Woman C.P.A.

Volume 36 | Issue 4 Article 11

10-1974

Woman CPA Volume 36, Number 4, October 1974

American Woman's Society of Certified Public Accountants

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The Woman CPA

OCTOBER 1974 VOLUME 36, NUMBER 4

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The Woman CPA

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Page 1

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2. DATE OF FILING: October 1 1974
3. FREQUENCY OF ISSUE: QUARTERLY - January, April, July, October
4. LOCATION OF KNOWN OFFICE OF PUBLICATION (Street, city, county, state, ZIP code) (Not printers): 327 S. LaSalle Street, #738, Chicago, Illinois 60604 Cook County
5. LOCATION OF THE HEADQUARTERS OR GENERAL BUSINESS OFFICES OF THE PUBLISHERS (Not printers): 327 S. LaSalle Street, #738, Chicago, Illinois 60604
6. NAMES AND ADDRESSES OF PUBLISHER, EDITOR, AND MANAGING EDITOR

PUBLISHER (Name and address): AMERICAN WOMAN'S SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS and AMERICAN SOCIETY OF WOMEN ACCOUNTANTS

EDITOR (Name and address): DR. ULA K. MOTEKAT, CPA, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF MASSACHUSETTS, AMHERST, MASSACHUSETTS 01002

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Human Resource Accounting in Practice at R. G. Barry Corporation

Bertha Proffitt
Columbus, Ohio

From her first-hand knowledge the author explains an actual system of accounting for human resources.

Bertha Proffitt is General Accounting Manager for R. G. Barry Corporation. After working as a secretary for two years, she decided to move to Columbus and in her first interview, with R. G. Barry, she was given her choice of two openings: one in sales, one in accounting. She decided to take the job in the accounting department and has been with R. G. Barry now for 19 years – a record that speaks well of the Company's handling of its human resources.

Ms. Proffitt was selected to handle the Human Resource General Ledger when it was first established. Her article is based on her intimate knowledge of the Human Resource Accounting system used at R. G. Barry Corporation.

Ms. Proffitt is a member of the Columbus Chapter of the American Society of Women Accountants.

Over the years, much has been said and written about the fallacy of measuring only assets that have a physical tangible value or that can be reduced to cash while expensing outright the cost of building up a team of human beings that ultimately is responsible for the success of the business. Conventional thinking, the problem of deviating from the tax treatment of expenses for internal management purposes, SEC regulations, the inbred conservatism of accountants and many other considerations have delayed the accounting recognition of human resource values unduly long.

The Vital Ingredient

The importance of the human element in the operations of a business has long been acknowledged as evidenced by the many acquisitions and mergers that have been made primarily to obtain the management talent and the "team" of the acquired company or to take advantage of the goodwill built up by these people. Yet, this vital ingredient has always been left as an unidentified factor — after all, any fool could arrive at the conclusion that the more successful companies (among other things) probably had the better "brains".

The exception, the company that wanted to KNOW the value of its human resources, was R. G. Barry Corporation. It should be no surprise that the pioneer in the field of measuring human values came from the ranks of the apparel industry, since mechanization and automation have been extremely slow in that industry — hampered by frequent style changes and the small size of most companies. Therefore, labor — or people, if you will — represents a significant percentage of the manufacturing cost. The recognition of the central importance of people is manifested in the R.G. Barry Corporation's *Basic Purpose*: "(To) create a climate that stimulates, challenges and channels human intelligence, ingenuity and desire of our Associates to the fulfillment of our purpose and (to) provide them with a sense of achievement, equitable compensation, plus participation in the results of success".

In 1966, Gordon Zacks, President of R. G. Barry, contacted Dr. Rensis Likert at the Institute for Social Research, University of Michigan. Through Dr. Likert, the company was introduced to a team from the Institute headed by William C. Pyle, then its Director of Human Resource Accounting. Working together during the next 15 months, William Pyle, Professor Lee Brummet, Eric Flamholz and a top management team at R. G. Barry developed a system that would enable the company to account for its human resources. Figure 1 shows the flow of costs through the system as immediately expensed items or through asset accounts and, by way of amortization, back into the operating expense area.

At first, the system of Human Research Accounting (HRA) at R. G. Barry was limited to management personnel. In setting up the initial records, reasonable assumptions had to be made as to acquisition and development costs, but it is significant to note that these assumptions are still being used as "Standard Costs" (Figure 2). The "Beginning Balance Work Sheet" (Figure 3)

Figure 1

R. G. Barry Human Resource Accounting System for Investments in Managers (Outlay Costs)

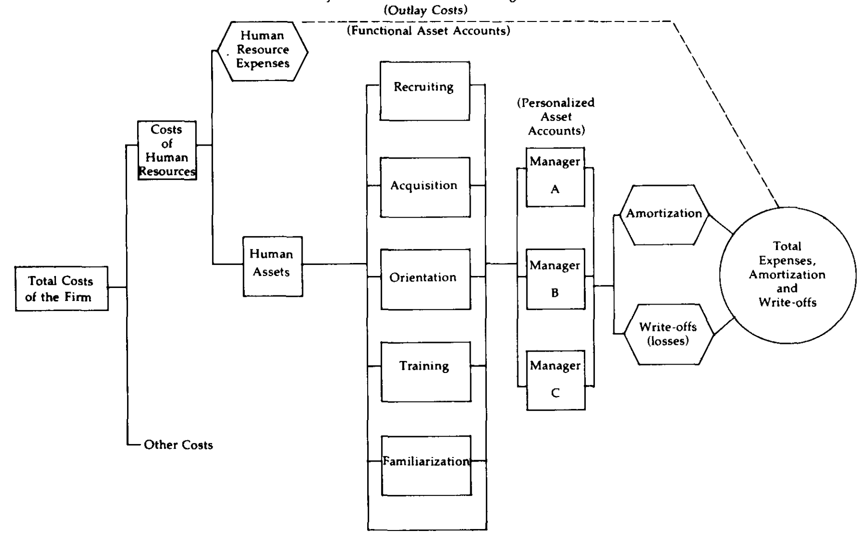


Figure 2

Master Standard Cost Table

Salary Grade	Recruiting	Acquisition	Orientation	Exit	Total
31	730	175	55	620	1,580
32	880	455	55	670	2,060
33	1,150	605	110	770	2,635
34	1,460	885	110	860	3,315
35	1,825	1,425	340	990	4,580
36	2,075	1,880	340	1,080	5,375
37	2,135	2,650	560	1,260	6,605
38	2,340	3,030	560	1,440	7,370
39	2,390	3,145	560	1,610	7,705
40	3,700	3,710	895	4,120	12,425
41	5,715	3,055	1,120	5,210	15,100
42	7,340	3,395	1,120	6,270	18,125
43	9,800	3,475	1,120	7,785	22,180
44	12,880	3,950	2,240	9,185	28,255

was developed. This very first form also is still being used. The next step was to determine a reasonable method of amortizing the investment in human resources. The "Expected Tenure Formula" was developed (Figure 4). The "Maximum Life Period" is, of course, the difference between the new employee's present age and age 65. The amortization period for management personnel is the Expected Tenure multiplied by the Maximum Life Period.

On January 1, 1968, R. G. Barry was ready to start its hand-posted ledger of Human Resource Accounting, consisting of the "costs" of 95 management employees. The information generated was reported to operating managers on a quarterly basis. Today, the management HRA ledger is still pretty much in the same form because of the confidentiality of much of the information contained therein, but now all the employees are included in the system, with the hourly paid employees' records being handled by computers. Since the nature as well as the scale of investments in factory and clerical personnel vary significantly from the human resource investments at the management level, the system for hourly-paid and clerical associates was limited to recording only acquisition, orientation and training costs. Also, the formula for determining the amortization period (Figure 5) differs somewhat from the Expected Tenure Formula for management personnel.

Capitalization vs. Immediate Expensing

It goes without saying that the criteria for capitalizing investments in human resources are no different from those used in the acquisition of fixed assets. An expenditure must reasonably be expected to benefit

Figure 3

Beginning Balance Work Sheet

Name: ______________ Position: ______________ Date of Hire: ______ Lifetime

Date of Birth: ______ Amort. Per. ______

Date Assumed Present Position: ______________ Salary Grade: ______

ACCOUNT CLASSIFICATION	AMORTIZATION PERIOD	=	COST	−	AMORTIZATION	=	BEGINNING BALANCE
Recruiting	______	=	______	−	______	=	______
Acquisition	______	=	______	−	______	=	______
Orientation	______	=	______	−	______	=	______
Training	______	=	______	−	______	=	______
Familiarization	______	=	______	−	______	=	______
Formal Development	______	=	______	−	______	=	______
Informal Development	______	=	______	−	______	=	______
Exit	______	=	______	−	______	=	______
Other	______	=	______	−	______	=	______
TOTAL	______	=	______	−	______	=	______

the company over a longer period of time (usually in excess of 12 months) to qualify as a capital asset. Looking at the amounts that are customarily spent in the acquisition of personnel, there is no question that they are eligible if the expected "life" qualifies.

There are two different types of costs that are recorded: (a) direct costs, or out-of-pocket expenditures, such as advertising fees, placement fees, travel for the applicant, hotel bills, meals, outside testing, etc., and (b) allocated costs which are based on the time spent by the Human Resource Department and the Department Manager. The estimated time for all persons working on the recruiting and acquisition is multiplied by the midpoint of the salary range of the personnel involved to find the allocated cost figure. An allocation is made for the expenses incurred for interviewing persons that do not meet the requirements for the job or decide that they do not wish to accept the job.

The Functional Costs

The system consists of seven functional cost accounts:

1) *Recruiting.* This category comprises the cost of locating new personnel, money spent for advertising, travel expenses for interviewers and interviewees, etc. Internal as well as external recruiting costs are incurred for both successful and unsuccessful job candidates, while the balance of the functional human resource costs are limited to employees of the corporation.

2) *Acquisition.* The most prevalent expenses are placement fees, moving expenses, the cost of physical examinations, temporary living expenses and travel allowances until the family of the new employee can be relocated.

3) *Formal training and familiarization costs* are incurred in connection with formal orientation and training programs, which may be in-house or at another location. This type of cost applies to newly-hired employees as well as associates transferred from other departments.

4) *Informal training costs* are associated with the process of teaching new associates to adapt their skills to the new job.

5) *Familiarization costs* are truly hidden costs. They consist of the time required to learn the company's philosophy, objectives and understanding of the people with whom the new associate will interact. This can range from the first-day "How-do-you-do?" of the new hourly-paid factory worker to the many days spent by new managers in learning to know their "team" and finding the best way to motivate and supervise their employees.

Figure 4

Expected Tenure Formula: MANAGEMENT

Weights

Age Factor	=	.50
Tenure Factor	=	.25
Level Factor	=	.25

PROBABILITIES

Age	*M/L*	*Tenure*	*M/L*	*Salary Level*	*M/L*
Up to - 25	.4	Up to 5 yrs	.5	31	.7
26 - 30	.5	6 - 10	.6	32	.6
31 - 35	.5	11 - 15	.7	33	.5
36 - 40	.5	16 - 20	.8	34	.5
41 - 45	.6	21 - 25	.95	35	.5
46 - 50	.9	26 - 30	.95	36	.6
51 - 55	.9			37	.6
56 - 60	.95			38	.8
61 - 65	.96			39	.8
66 - 70	1.00			40	.8
					.85
					.9
					.9

EXAMPLE: 27 yr. old; 3 yrs tenure; Salary Grade 32

Age	.5 x .5 = .25			
Tenure	.25 x .5 = .125			
Salary Grade	.25 x .6 = .150			
	.525			

For each person:

(Age Factor)	x .5 =	
(Tenure Factor)	x .25 =	
(Salary Factor)	x .25 =	______

Answer x Maximum Life Period

6) *Investment building experience costs* are related to on-the-job training which occurs after the initial familiarization period. They are expected to have value to the company beyond the current accounting period and hence "build" the investment in the new associate.

7) *Development costs* are incurred when a person attends a seminar or takes a course at a university. The costs collected in this category are the person's time spent away from the job, the seminar fees and expenses for travel, meals and lodging. The departmental managers are responsible for reporting any Development or Investment Building Experience costs incurred by any of their personnel.

The Effect on the Income Stream

Human Resource account balances are amortized annually based on the expected working life of the associate for all functional costs except training, which is amortized over a four-year life, and development costs, which have been assigned a six-year life. A particular development cost could be obsolete in a much shorter period of time, and if that occurs the manager instructs the Human Resource Department to write off the cost item at the end of the quarter in which it becomes obsolete. When associates leave the company, their accounts are written off entirely.

Starting in 1970, a "Human Resource Capital Plan" was developed for the use by managers. This plan enables them to compare their actual experiences as reflected on the quarterly reports with their expectations as far as investments and write-offs are concerned.

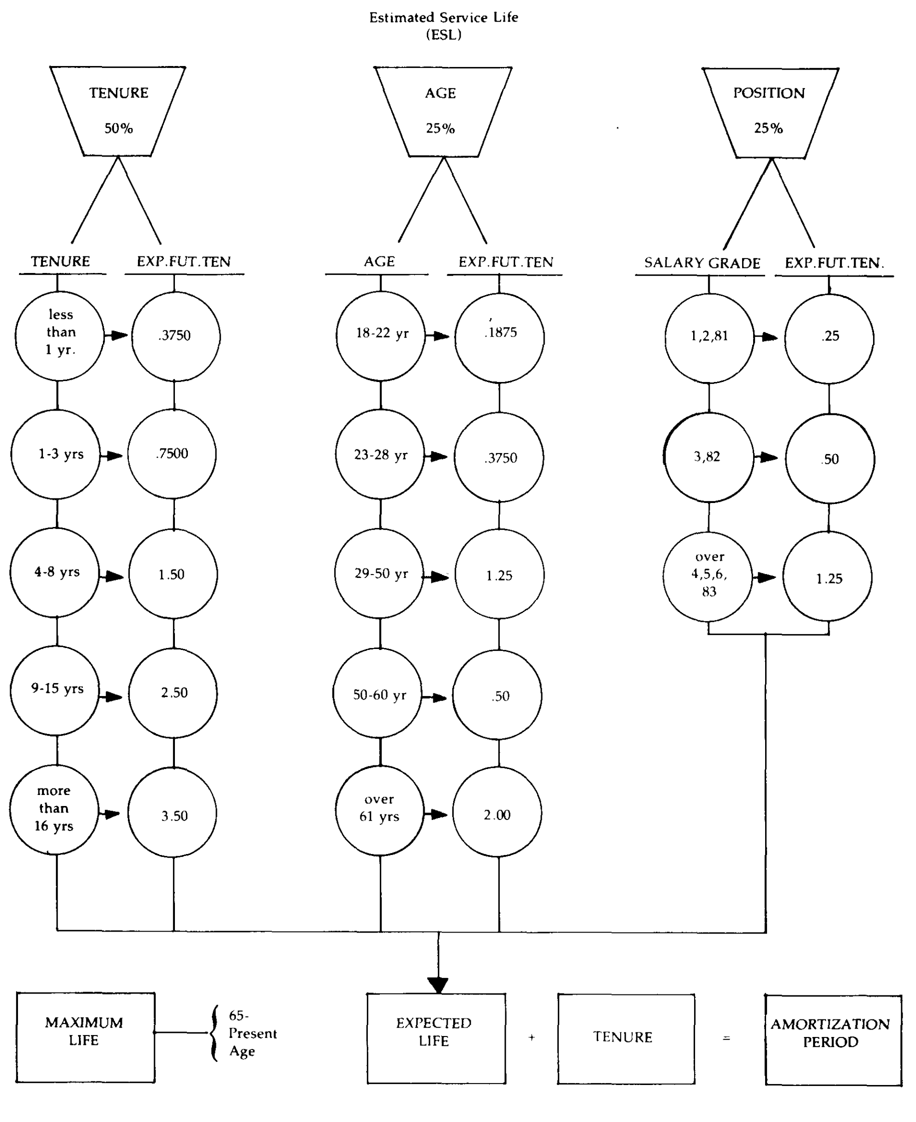
Hiring Procedures With Human Resource Costs in Mind

When a new position is created, or if a vacancy occurs because of separation or a promotion, the immediate supervisor sends a Request for Personnel to the Human Resource Department for action. The latter coordinates the recruiting and acquisition efforts with the divisional manager. The Human Resource Department also develops recruiting and acquisition cost standards for similar job classifications within the firm. The company has adopted the policy that all job openings must first be offered to associates before any outside recruiting can be done. In case of a management job, a notice is sent to all managers, and in the case of an hourly-paid position, the opening is posted on the News Center.

It goes without saying that in most instances associates of the company will be "cheaper" to acquire than outsiders. Their initial recruiting costs are already partially amortized, even though there would be an adjustment in the investment for the upgraded salary level if a promotion is involved. On the other hand, an associate may transfer to another department for personal reasons, and no adjustment may be required. This policy undoubtedly has many side-benefits, such as increased interest in the company on the part of associates and increased employee loyalty, since they can be assured that they will have first chance at promotion when openings occur.

Recognizing the human element of the business as having true economic value affects managerial thinking in many important ways, too. First of all, it cannot help but heighten the awareness of managers of the economic importance of people. Secondly, the human resource write-offs reflected in the quarterly reports highlight the fact that rapid personnel turn-over is costly. Thirdly, development of people takes on a different light when it is expressed in dollars-and-cents. Fourth, the income statement is really enhanced by reflecting the investment in, and the amortization and write-offs of human resource costs. Last, but certainly not least, a review of the human resource costs by department or other cost center, gives top management another opportunity to appraise the performance of the company's lower-level managers.

Figure 5



Effect on the Balance Sheet

So far, considerations have concentrated on the profit and loss area. Reflecting investments in human resources on the balance sheet does create problems. Regulatory agencies will not permit such practices, for tax purposes it would be undesirable to convert a presently deductible cost into a capital asset, and financial analysts and the financial press might label the practice of showing such investments as "padding" the balance sheet. The R. G. Barry Corporation has shown Human Resource Investments as a "line item" on their balance sheet with the sanction of their auditors. However, until this practice is more widely accepted, it will require a lot of disclosure and explanation.

Summary

Although still in its infancy and constantly developing, it can be said that accounting for human resources has already proved that it is a valuable management tool in the evaluation of performance and in the planning for the future and for expansion. It will, undoubtedly, become an accepted method of financial accounting at some future date, simply because the steadily increasing complexity of management requires the availability of ALL financial and economic data about the business. First-rate managers have a "feel" for their personnel situation, or they would not be where they are. But they deserve the aid of the tool that is designed to take much of the guesswork out of personnel decisions — the system of Accounting for Human Resources.

Pooling of Interests vs. Purchase: Effects on EPS

Dr. Ruth H. Bullard, CPA
New Orleans, Louisiana

The author describes a study she made of 34 mergers which were treated as poolings of interests and the results she obtained when she restated these mergers as purchases.

Dr. Ruth H. Bullard, CPA, is currently Associate Professor of Accounting at The University of Texas at San Antonio. She received her CPA license from the state of Texas.

Dr. Bullard had several years of varied business experience in both government and private industry before entering Mary Hardin Baylor College where she received a B.S. degree. She also holds an MBA and a Ph.D. degree from The University of Texas at Austin. She taught accounting at McLennan Community College, at The University of Wisconsin at Green Bay, and Louisiana State University at New Orleans before accepting her current appointment.

Introduction

In recent years "pooling of interests" versus "purchase" in accounting for business combinations has been one of the most critical issues in the accounting profession and the business community. Abuses in accounting for business combinations and consequent criticism have led to the issuance of *Opinions No. 16* and *17* by the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants. These opinions have had the affect of curbing many of the abuses exercised by corporations in their zeal to acquire new business through merger. In fact some may think that the "pooling" question has been settled. It is felt by some, however, to be one of the most fundamental problems, involving profound matters of entity, income measurement, and disclosure that still needs to be solved by the profession. Evidence for this concern is easy to find: in the last 2½ years there have been 39 interpretations dealing with *Opinion 16* in the *Journal of Accountancy;* a recent article identifies some still persisting problem areas[1]; *Accounting Series Release Nos. 130* and *135* deal with directives regarding pooling-purchase accounting; and, according to information from the research division of the Financial Accounting Standards Board, pooling-purchase accounting is again in the forefront of their research activities.

Figure 1 graphically depicts the velocity and magnitude of the merger movement of the 1960's and the increasing concentration of assets by the 200 largest corporations. Figure 2 compares the three merger movements of the past 75 years.

Criticisms of the pooling method have run rampant. Charges have been levied by various writers at specific companies and specific mergers. Case studies of the merger activity of one selected company have been done[2], but no study has been attempted which determines the effects of pooling-purchase on earnings per share (EPS) of a random sampling from all large poolings occurring over a span of time. The purpose of this study is to provide information from such a study. The results of the study should either add credence to or refute the charges that pooling accounting does enhance EPS.

Study Procedures

The first phase of the study involves documenting the major business combinations occurring in the years 1967 through 1970. By use of a table of random numbers, a sample is chosen from the published list on large mergers.[3] Each merger selected meets the criteria of being accounted for as a pooling of interests and the surviving company being listed on the New York Stock Exchange. This limitation is imposed since these companies are representative of the major public companies, and the earnings of these companies are of the greatest interest to the largest number of shareholders. Also, since these firms are among the largest, their inclusion represents a significant proportion of the total acquisition activity occurring in the period under review. Furthermore, a practical reason for using public companies is that certain information concerning their merger and acquisition activity is available in published annual reports.

An analysis of each merger selected for the study is conducted in which the business combination is restated as a purchase. Any excess of the market value of the stock given over the book value of the assets received is classified as goodwill. Such goodwill is amortized, on a basis of a forty-year life, against reported earnings per share.

A comparison is set up to compare the earnings per share (EPS) reported by the company on a pooling basis in the year of acquisition against the previous year's earnings as restated to meet APB requirements.

A second comparison is made of the earnings resulting from a restatement of the business combination as a purchase.

A third item considered is the percent change in the earnings of the year of acquisition as a result of restatement as a purchase.[4]

Analysis of the Sample Mergers

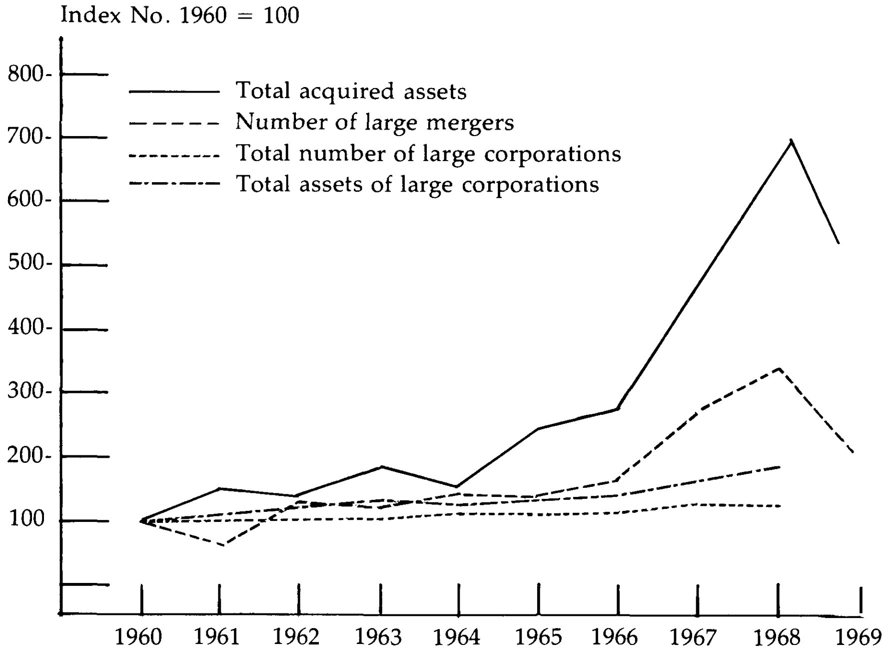
Fifty mergers meeting the previously determined criteria are selected from Statistical Report No. 7. Investigation of the financial statements of each selected merger reveals that sixteen of the fifty poolings selected are actually not true poolings of interest but rather are some hybrid of partial control, part purchase-part pooling, or some circumstance[5] that eliminates them from the sample. The financial statements of the remaining 34 mergers are restated from the pooling of interests methods of accounting to the purchase method of accounting.

Some assumptions necessary for restatement are:

1. The two companies are combined on the basis of their last published financial reports before the merger.
2. Goodwill is derived by taking the difference between the market price of the stock issued in the transaction on the date of the completion of the merger and the net book value of the assets received by the acquiring firm. In one instance preferred stock is issued but not sold publicly. The preferred stock is converted to common and the price of the common is used for the computation.
3. The closing market price on the date

Figure 1

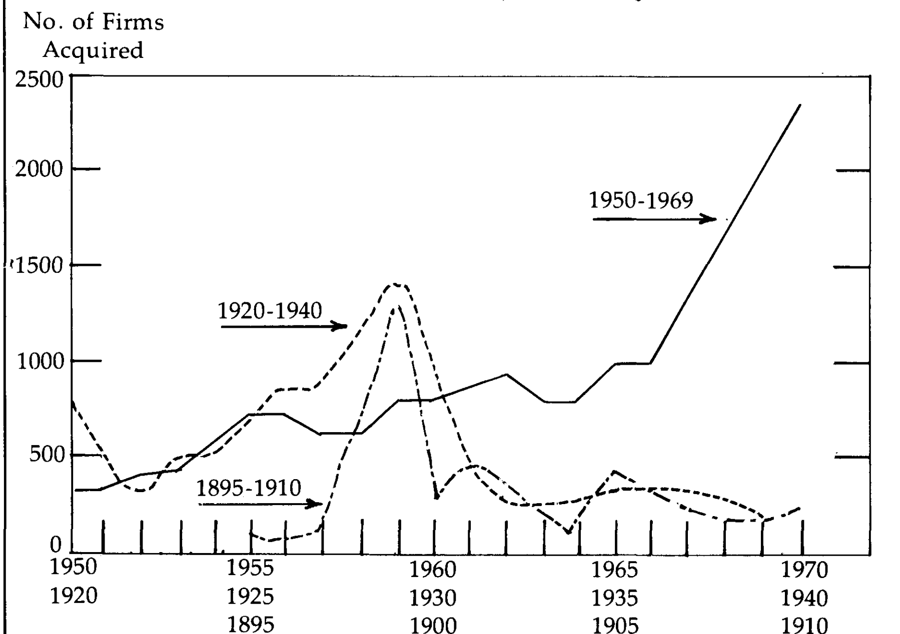
TRENDS IN LARGE FIRMS ACQUIRED
COMPARED WITH TOTAL LARGE CORPORATIONS
IN MANUFACTURING AND MINING, 1960-1969



SOURCE: Bureau of Economics, Federal Trade Commission, *Current Trends in Merger Activity*, 1970, Statistical Report No. 8, p. 6.

Figure 2

THREE MERGER MOVEMENTS COMPARED
MANUFACTURING AND MINING ACQUISITIONS



SOURCE: Bureau of Economics, Federal Trade Commission, *Economic Concentration*, 1969, Staff Report of the Federal Trade Commission, Economic Report on Corporate Mergers, p. 32.

Table 1

MERGER ANALYSIS

Col. 1 Companies	Col. 2 Total Shares Issued as % of Total Equiv. Shares	Col. 3 Calculated Goodwill (millions)	Col. 4 Book Value of Acquired Company (millions)	Col. 5 Goodwill as % of Book Value Col. 3: 4	Col. 6 Total Assets of Acquiring Company Including Goodwill (millions)	Col. 7 Goodwill as % of Total Assets Col. 3: 6	Col. 8 Acquired Book Value as % of Total Assets Col. 4: 6
Atlantic Richfield Company Nuclear Materials Corporation	0.4%	$ 1.7	$ 6.0	27.8%	$1,673.0	0.1%	0.3%
Warner-Lambert Pharm. Co. American Optical Company	17.2%	195.6	65.5	298.6%	616.1	31.7%	10.6%
Pitney-Bowes, Inc. Monarch Marking Company	21.5%	64.6	18.7	344.5%	237.3	27.2%	8.0%
Tenneco, Inc. Kern County Land Company	5.8%	228.6	184.1	124.1%	3,692.8	6.2%	4.9%
Textron Incorporated Gorham Corporation	2.9%	14.8	21.4	68.9%	546.5	2.7%	3.9%
Armstrong Cork Company E & B Carpet Mills Company	2.0%	9.0	2.0	457.1%	320.3	2.8%	0.6%
Plough Incorporated Maybelline Company	27.8%	90.0	7.3	1,230.6%	154.1	58.4%	4.7%
Kerr McGee Oil Company American Potash Company	12.7%	32.7	75.4	43.3%	533.7	6.1%	14.1%
E. R. Squibb & Sons Beech-Nut Lifesavers Company	26.6%	96.5	134.3	71.9%	519.1	18.5%	25.8%
Occidental Petro. Corp. Island Creek Coal Company	9.7%	70.6	80.9	87.2%	628.5	11.2%	12.8%
American Can Company Butterick Company	2.6%	23.1	4.3	532.3%	1,120.1	2.0%	0.4%
U.S. Industries, Inc. Big Dutchman, Inc.	2.6%	(3.5)	12.4	28.4%	188.6	1.8%	6.8%
White Consolidated Industries Bullard Company	5.9%	(3.9)	21.8	17.8%	155.8	2.5%	14.0%
International Tel. & Tel. Rayonier	7.2%	142.2	159.8	89.0%	3,399.7	4.1%	3.4%
Teledyne Incorporated Landis Machine Company	3.2%	60.8	14.2	427.7%	415.7	14.6%	3.4%
Teledyne Incorporated Packard Bell Inc.	1.1%	(4.6)	10.0	46.3%	367.3	1.2%	2.7%
J. P. Stevens Company, Inc. United Elastic Corporation	11.4%	15.9	29.3	54.2%	627.2	2.5%	4.6%
Milton Bradley Company Playskool Company	18.8%	15.5	8.1	190.5%	59.2	26.1%	13.8%
Occidental Petro. Corp. Hooker Chemical Company	37.6%	548.2	219.9	249.3%	1,693.8	32.4%	13.0%
Sundstrand Corporation Falk Corporation	14.3%	22.0	35.5	62.1%	289.7	7.6%	12.3%
Xerox Corporation Scientific Data Systems	12.9%	833.2	78.3	1,064.3%	1,852.2	44.9%	4.2%
Sunshine Mining Company Anchor Post Prod. Company	10.0%	3.2	8.3	38.9%	43.8	7.3%	18.9%
Beatrice Foods Company E. R. Moore Company	1.3%	6.0	7.0	86.0%	456.8	1.3%	1.5%
ESB, Incorporated Universal Electric Company	5.9%	0.2	7.6	2.7%	148.8	0.1%	5.1%
International Tel. & Tel. Grinnell Corporation	5.1%	94.2	156.8	59.8%	4,301.0	2.2%	3.8%
Ashland Oil Incorporated Midhurst Oil Company	4.7%	14.4	20.4	70.5%	787.8	1.8%	2.6%
Armco Steel Corporation Hitco Incorporated	10.4%	82.3	32.8	251.1%	1,776.2	4.7%	1.8%
Illinois Central Ind. Pepsi-Cola Gen. Bot.	9.1%	26.0	19.0	136.7%	1,158.2	2.2%	1.6%
RCA Corporation F. M. Stamper Company	5.3%	107.6	33.0	326.7%	2,786.5	3.8%	1.2%
International Tel. & Tel. Gwaltney, Inc.	0.7%	23.6	10.9	216.9%	5,229.8	0.5%	0.2%
Warner-Lambert Pharm. Company Parke-Davis Company	22.5%	217.5	214.9	101.1%	1,188.2	18.3%	0.9%
Screw & Bolt Corp. of America Ampco Metal Inc.	48.0%	3.4	11.6	29.1%	57.4	5.9%	20.1%
Johnson Services Company Penn Controls Incorporated	22.4%	15.4	11.1	137.5%	86.5	17.8%	12.8%

of completion of the merger is used (for lack of a better date) so that all the analyses are made in the same manner. The price of the stock on this particular date may not be a good measure of the price of the stock on the date that the two managements actually came to an agreement on the amount of stock to transfer in the transaction. There is no way of knowing on what date such an agreement is actually made.

4. Paid-in capital is derived by including the paid-in capital of the acquiring firm with the difference between the par value of the stock issued in the transaction and the equity displaced (the capital stock and the paid-in capital) of the acquired firm.

5. The goodwill generated in the restatement as a purchase transaction is amortized against earnings on the basis of a 40-year period in accordance with *Opinion 17*.

6. The EPS reported on the pooling basis is the EPS as reported by the merged company in the year of the combination; it is compared with the EPS as restated by the merged company to give effect to the pooling in the previous year.

7. The EPS reported on the purchase basis is the EPS reported by the merged company in the year of the merger adjusted by amortization of any goodwill generated in the transaction. This adjusted EPS is compared with the previous year's EPS as reported by the acquiring company.

Table 1 is a compilation of the dollar value of the goodwill generated in the restatement and a percentage comparison of such goodwill with the book value of the acquired company and with the total assets of the acquiring company. Table 1 also shows the percentage comparison of the total shares issued in the transaction to the total equivalent shares of the acquiring company.

Table 2

VERTICAL CHANGES IN EARNINGS PER SHARE
IN YEAR OF MERGER

Company	EPS Pooling As Reported By Acquiring Co.	EPS Purchase As Restated With Amortiz. Goodwill	Percent Change
Plough Inc.	$3.64	$2.85	−21.7
Xerox Corporation	2.08	1.81	−13.0
Kerr McGee Oil Co.	4.54	4.06	−10.6
Pitney-Bowes Inc.	2.50	2.24	−10.4
Milton Bradley Inc.	1.06	.95	−10.4
Warner-Lambert Pharm. Co.	1.71	1.55	− 9.4
Occidental Pet. Corp.	2.04	1.85	− 9.3
Screw & Bolt Corp. of Am.	.71	.66	− 7.0
Amerada Petroleum Co.	2.38	2.23	− 6.3
E. R. Squibb & Sons	2.16	2.03	− 6.0
Johnson Services Co.	3.30	3.11	− 5.8
Teledyne Inc.	3.22	3.08	− 4.3
Sunshine Mining Co.	.51	.49	− 3.9
R.C.A. Corp.	1.26	1.22	− 3.2
I.T.T. Inc.	2.80	2.71	− 3.2
Sundstrand Corp.	2.89	2.80	− 3.1
Beatrice Foods Co.	1.99	1.93	− 3.0
Armco Steel Corp.	3.09	2.94	− 2.3
Warner-Lambert Pharm. Co.	2.57	2.51	− 2.3
Occidental Pet. Corp.	1.04	1.02	− 1.9
I.T.T. Inc.	2.66	2.61	− 1.9
Illinois Central Ind.	2.72	2.68	− 1.5
J. P. Stevens Co., Inc.	5.02	4.96	− 1.4
Tenneco, Inc.	1.81	1.79	− 1.1
Armstrong Cork Co.	2.50	2.48	− .8
American Can Co.	3.30	3.28	− .6
Ashland Oil Inc.	2.15	2.14	− .5
Textron Inc.	2.07	2.06	− .5
Atlantic Richfield Co.	6.46	6.45	− .2
Teledyne Inc.	3.22	3.22	0.0
E.S.B. Inc.	2.03	2.03	0.0
I.T.T. Inc.	3.09	3.09	0.0
White Consolidated Ind.	2.97	3.00	+ 1.0
U.S. Industries, Inc.	2.17	2.23	+ 2.8

SOURCE: EPS Pooling as reported by various companies. EPS Purchase as restated in analysis.

Analysis of Changes in EPS Due to Restatement

Amortization of the positive goodwill generated in the restatement results in negative impact on EPS of the acquiring company, while amortization of the negative goodwill so generated results in a positive effect on their EPS.

Vertical Change

The amortization of positive goodwill creates varying degrees of negative impact on the EPS_t[6] of the acquiring companies. Such changes range from 0% change to −21.7% change (Table 2).

The greatest negative change is in EPS of Plough, Inc. Plough issued 27.7% of its capital stock for assets totaling 4.7% of its total assets following the merger (including goodwill). Positive goodwill of over $90 million (Table 1) is created, amounting to over 1,200% of the book value of Maybelline. When this goodwill is amortized against earnings the resulting effect is to decrease EPS_t by 21.7% from $3.64 per share to $2.85 per share.

Xerox issued 12.9% of its capital stock for assets totaling 4.2% of its total assets following the merger (including goodwill). The $833,220,553 goodwill generated in this transaction is the largest dollar amount of any company studied and amounted to more than 1000% of the book value of the acquired company. However, because of the greater size of the acquiring company a smaller impact is noted on the financial statements of Xerox: a −13.0% change in EPS_t or a reduction from $2.08 per share to $1.81 per share.

Five other companies have negative changes of approximately 10% in their EPS_t from restatement of financial data, making a total of 21% of the companies studied with decreases in EPS_t of 10% or more.

Only 5.9% of the mergers under study show positive changes in EPS_t, and the largest positive effect on EPS_t is an increase of 2.8% in the earnings per share of U.S. Industries.

Table 3

HORIZONTAL CHANGE IN EARNINGS PER SHARE
(Year prior to merger compared to year of merger)

Companies	Pooling EPS_{t-1}	Pooling EPS_t	Percent Change	Purchase EPS_{t-1}	Purchase EPS_t	Percent Change	Net Change
Textron Inc.	$1.94	$2.07	+ 6.7	$3.53	$2.06	−41.6	−48.3
Plough Inc.	3.03	3.64	+20.1	3.32	2.85	−14.2	−34.3
J. P. Stevens, Inc.	3.91	5.03	+28.7	4.14	4.95	+ 4.3	−24.4
Xerox Corp.	1.68	2.08	+23.8	1.75	1.81	+ 3.4	−20.4
Occidental #2	1.04	2.04	+96.1	1.02	1.85	+81.3	−14.8
Illinois Central	2.59	2.72	+ 5.0	2.88	2.68	− 6.9	−11.9
Screw & Bolt Corp.	1.08	.71	−34.2	1.22	.66	−45.5	−11.3
I.T.T. #3	2.58	3.09	+19.8	2.80	3.09	+10.0	− 9.8
Pitney-Bowes	2.17	2.50	+15.2	2.10	2.24	+ 6.8	− 8.5
Milton Bradley	1.32	1.06	−19.7	1.32	.95	−38.0	− 8.3
Johnson Services	3.13	3.30	+ 5.4	3.15	3.11	− 1.3	− 6.7
Warner-Lambert #1	1.83	1.72	− 6.5	1.78	1.55	−12.9	− 6.4
Amerada Pet. Co.	2.42	2.38	− 1.7	2.42	2.23	− 7.9	− 6.2
Teledyne #1	2.44	3.22	+31.9	2.44	3.08	+26.2	− 5.7
Kerr-McGee	4.38	4.54	+ 3.7	4.04	4.06	+ 0.5	− 3.2
Armco	2.96	3.01	+ 1.7	2.98	2.94	− 1.3	− 3.0
Occidental #1	.71	1.04	+46.5	.71	1.02	+43.7	− 2.8
I.T.T. #2	2.68	2.80	+ 4.5	2.66	2.71	+ 1.9	− 2.6
Ashland Oil	2.06	2.15	+ 4.4	2.10	2.14	+ 1.9	− 2.5
Beatrice Foods	1.91	1.99	+ 4.2	1.89	1.93	+ 2.1	− 2.1
I.T.T. #1	2.26	2.66	+17.7	2.25	2.61	+16.0	− 1.7
R.C.A. Corp.	2.24	1.26	−44.5	2.25	1.22	−46.0	− 1.5
Tenneco	1.76	1.81	+ 2.8	1.76	1.79	+ 1.7	− 1.1
Armstrong	2.97	2.50	−15.8	2.93	2.48	−15.3	− .5
Atlantic Richfield	5.67	6.46	+13.9	4.67	6.45	+13.8	− .1
Teledyne #2	2.44	3.22	+31.9	2.44	3.22	+31.9	0.0
American Can	4.18	3.30	−21.1	4.18	3.28	−21.5	+ .4
Warner-Lambert #2	2.49	2.57	+ 3.2	2.39	2.51	+ 5.0	+ 1.8
Sunshine Mining	.68	.51	−25.0	.71	.49	−21.0	+ 4.0
White Cons. Inc.	4.52	2.97	−34.3	4.29	3.00	−30.1	+ 4.2
E.S.B. Inc.	1.42	2.03	+42.9	1.35	2.03	+50.4	+ 7.5
Sundstrand	2.73	2.89	+ 5.9	2.38	2.80	+17.7	+11.8
U.S. Ind.	1.97	2.17	+10.2	1.54	2.23	+44.7	+34.5
E.R. Squibb	2.16	2.16	0.0	1.39	2.03	+46.0	+46.0

SOURCES: Pooling EPS_t are those EPS as reported by the company in the present time period, EPS_{t-1} are those EPS as restated by the company for the year prior to the merger to reflect the pooling. Purchase EPS_t are those EPS as derived by restatement of the business combination as a purchase; EPS_{t-1} are the EPS as originally reported by the company in the year prior to the merger.

It becomes evident why companies use the pooling of interest method of accounting for business combinations when negative changes in EPS such as those demonstrated above result from the use of purchase accounting. By use of pooling, these effects on EPS are avoided. Other facts such as the larger percentage of capital stock issued for small amounts of increase in assets are also hidden in the financial statement.

Horizontal Changes

Many investors apparently are more interested in the percent change in EPS from year to year than they are in the absolute dollar amount of EPS in any one year. As pointed out by McEnally, the results of a test using present earnings divided by prior period earnings (E_t/E_{t-1}) yield correlation coefficients significant at the .1 percent level.[7] Therefore, as earnings of the present are more significant when compared with earnings of the prior period, the reporting of increased earnings will positively affect prices and volumes of that company's stock (because of the preferential treatment by the investor).

When comparing EPS_{t-1} with EPS_t, restatement as a purchase results in negative changes in 73.5% of the cases and in positive changes in 23.5% of the cases (Table 3).

The greatest impact on this year-to-year comparison occurs in Textron. Under pooling EPS_{t-1} of $1.94 (as restated by Textron to reflect their poolings) compared to EPS_t of $2.07 (as reported by Textron in the year of the merger) shows a 6.7% increase. Under purchase accounting EPS_{t-1} of $3.53 (as originally reported by Textron) when compared to EPS_t of $2.06 (adjusted for the amortization of goodwill) shows a 41.6% decrease. This is a net change of −48.3 percentage points and changes a plus into a minus. Reference to Table 2 indicates, however, that there is little change in the EPS_t from restatement, only a .5% decrease from $2.07 to $2.06. The unusually large change in comparison results from the restatement by Textron of their prior years' earnings to reflect their poolings. These figures evidently reflect other poolings than Gorham as it is not conceivable that this great change occurs from just this one relatively small pooling in which Textron gives 2.9% of its capital stock and receives assets amounting to 3.9% (Table 1) of total assets after merger (including goodwill).

Plough has a decrease of 34.3 percentage points from +20.1% in $year_{t-1}$ to −14.2% in $year_t$ as a result of restatement (Table 3). These changes are specifically the result of their pooling with Maybelline as this is the only merger reported by Plough in this year. The EPS_t for Plough is also significantly affected with a −21.7% change (Table 2).

While the EPS_t of J. P. Stevens shows little effect from restatement (−1.4%, Table 2), the change in the comparative percentage from $year_{t-1}$ to $year_t$ (Table 3) is a significant −24.4 percentage points.

It is difficult to determine the exact effects on many of the companies' earnings because 23.5% (8) of them failed to restate their prior year's earnings to reflect the polings and because the companies (except Plough) had other poolings which occurred in the year in question.

The large negative changes occurring in the majority of the restatements add credence to the charge that companies choose the pooling of interest method of accounting for mergers in order to minimize the negative impact on EPS[8].

Eighteen percent of the companies under study, however, appear to refute such charges, particularly the pooling of E. R. Squibb and Beech-Nut Lifesavers in which use of the purchase method of accounting increases the year-to-year comparison from 0.0% change to +46.0% change. (Table 2 shows the negative impact on EPS_t is only −6.0%.)

Another merger in this category is that of U.S. Industries and Big Dutchman. Negative goodwill of $3,544,600 is generated in the restatement, the amortization of which increases EPS_t by +2.8% (Table 2). The comparison of EPS_{t-1} to EPS_t also improves under purchase accounting from +10.2% to +44.7% (Table 3) or an increase of 34.5 percentage points. While it is difficult to extrapolate the results of this one merger on U.S. Industries' earnings, it appears that purchase accounting definitely improves its earnings picture for the year of this transaction.

In the Sundstrand-Falk merger purchase accounting decreases absolute EPS_t by 3.1% (Table 2) but the comparison of $year_{t-1}$ to $year_t$ (Table 3) changes the growth in earnings from +5.9% under pooling to +17.7% under purchase accounting.

Amortization of the positive goodwill generated in the restatement of the ESB-Universal merger had a zero effect on EPS_t (Table 2) but the comparison from $year_{t-1}$ to $year_t$ is improved by 7.5 percentage points (Table 3).

The results of the horizontal changes are not as clear-cut as those of the vertical changes. The number of variables entering into the computation and affecting the results practically negate a firm conclusion on these changes. When the vertical and horizontal effects are considered together, however, the conclusion is clear that the pooling of interest method of accounting does improve the earnings picture of the merged companies, whereas the use of purchase accounting has an adverse effect on EPS in the majority of cases.

Other Factors from Analysis

Many companies include a merger occurring in the first 4 months of the year in their previous year's financial statements. Of the 34 mergers under study ten took place in the first 4 months of the year: Squibb & Sons-Beech-Nut, Occidental Petroleum-Island Creek Coal, American Can-Butterick, Illinois Central Industries-Pepsi-Cola, White Consolidated-Bullard, Atlantic Richfield-Nuclear Materials, U.S. Industries-Big Dutchman, RCA-Stamper, Warner-Lambert-American Optical, and ITT-Rayonier. Of these 10 companies the first six, or 60% include the merger with their prior year's financial statements. This, of course, is one of the abuses of merger accounting which is eliminated by the issuance of *Opinion 16.*

Of the 34 mergers analyzed, 8 companies either do not restate their prior year's earnings to include the effects of the merger or there is no effect on their earnings as a result of restating to reflect the pooling: Atlantic Richfield-Nuclear Materials, Tenneco-Kern County Land, Occidental Petroleum-Island Creek Coal, American Can-Butterick, Teledyne-Landis, Teledyne-Packard Bell, Milton Bradley-Playskool, and Amerada Petroleum-Hess Oil & Chemical.

In other words, almost a quarter of the companies under study fail to restate prior year's earnings to include the effects of the pooling of interest. It is highly unlikely that all of the above listed mergers result in no change in earnings, especially in view of the fact that all the companies under study had other mergers besides the one studied with the exception of Milton Bradley-Playskool. This is another of the abuses *Opinion 16* eliminates.

It is further noted that at least three companies fail to present earnings on a fully diluted basis, at least not as stipulated in *Opinion 15.*

The most glaring discrepancy in the financial statements of the companies under study is the lack of adequate disclosure. It is very disconcerting to attempt analysis of a financial statement and find inconsistencies and variations in descriptive information. Disclosures are usually only brief comments. Rarely, if ever, are such disclosures sufficient for thorough analysis or conversion of the statement to some other accounting alternative. In short, there is insufficient disclosure to adequately analyze the effects of business combinations. In many instances there is no disclosure of:

1. The companies merged.
2. The amounts or form of compensation given for the acquiree.
3. The contribution of the newly acquired company to consolidated net income.
4. The method of valuation used to determine "what they pay for what they get".
5. The method of valuation of the assets received in the transaction.

It is necessary to rely on information other than accounting data to make the analyses, and, as stated earlier, when this data is unavailable there is really no way of making a meaningful analysis.

Other interesting points from the analyses (Table 1) include the seventeen companies in which the goodwill generated by restatement of the merger as a purchase transaction is very large in comparison to the book value of the acquired company.

Restatements result in the creation of goodwill in excess of 100% of the book value of the acquired company in 50% of the mergers under study. Critics may point out that a great part of the increase included in goodwill in this study is really the fair market value of the assets acquired especially where patents and technology are involved. The fact remains that whether these increases are lumped into goodwill or apportioned to the assets acquired, the effects (other than effects of timing) on EPS are substantially the same.

As stated earlier, the capitalization of such large amounts of artificially generated goodwill has a negative effect on accounting attributes other than EPS, such as rate of return. Since this analysis is made primarily from the standpoint of the effects on EPS, effects on other accounting attributes are not analyzed.

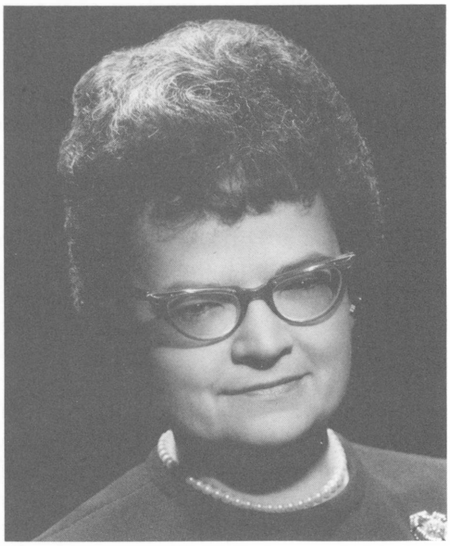
Summary and Conclusion

Restatement from pooling to purchase accounting results in generation of negative goodwill in three instances (11.8%) while 31 instances (88.2%) of positive goodwill were found. Amortization of the goodwill generated in the restatement results in changes in EPS_t varying in degree of impact from +2.8% to −21.7% and negative impact on the year-to-year comparison EPS_{t-1} to EPS_t in 26 instances (73.5%).

On the basis of this study it is concluded that, in the majority of cases, the pooling of interest method of accounting results in greater reported earnings per share than the purchase method, and that, in the majority of cases, the purchase method of accounting generates large amounts of goodwill, resulting in higher recorded asset values than under pooling and, when amortized, causing a lower EPS than under pooling.

It can therefore be concluded that pooling accounting does generally enhance the earnings of the merger companies, whereas purchase accounting has the opposite effect.

(Continued on page 16)



Theory & Practice

THE AICPA's AccSEC and AudSEC and the FASB

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AICPA - Accounting Standards Division Executive Committee

Since the AICPA relinquished its authority to issue authoritative, enforceable pronouncements on accounting principles to the FASB, the role of this Committee (AccSEC) in issuing pronouncements has been somewhat unclear. The FASB expressed its concern that the position papers which AccSEC was issuing would create "de facto" accounting standards. To resolve the problem, the Accounting Standards Division published its responsibilities and pronouncement policies in the July 1974 issue of *The CPA Letter:*

- The Accounting Standards Division has responsibility for maintaining liaison, on behalf of the AICPA, with the FASB, SEC, CASB (Cost Accounting Standards Board), stock exchanges and other bodies having authority over financial accounting and reporting standards.
- Responsibilities of AccSEC include:
  - Commenting on accounting and reporting standards and interpretations proposed by the FASB and other regulatory bodies.
  - Initiating accounting and reporting proposals.
  - Clearing references to accounting and reporting positions included in statements issued by any AICPA committee.
- Procedures of AccSEC with respect to pronouncement policies:
  - Written communications will be in two forms — Statements of Position, which will include a caveat that they do not establish enforceable standards, and less formal position letters.
  - Statements of Position will be prepared on each FASB discussion memorandum. Letters will be sent to the FASB commenting on its exposure drafts of standards and of interpretations.
  - Problems identified as requiring interpretation or a new standard will be described in letters to the FASB with suggested solutions when feasible.
  - Request for comments by government agencies and other regulatory bodies will be handled by letter and if an accounting principle or its interpretation is involved, a recommendation will be made that the matter be dealt with by the FASB.
  - AccSEC chairman will clear letters prepared by the AICPA's separate CASB committee commenting on proposals of the Cost Accounting Standards Board.
  - AccSEC chairman will approve Statements of Position prepared by AICPA task forces and addressed to the FASB proposing amendments to existing AICPA Accounting and Audit Guides.
  - AccSEC chairman will clear descriptions of current financial accounting and reporting practices (new practices may not be recommended) included in any new AICPA Audit Guide.

AccSEC has submitted comments on each FASB discussion memorandum and on various SEC proposals to amend its rules relating to financial statements and disclosures or affecting the work of the auditor. Several letters have been sent to the FASB requesting interpretation of specific paragraphs of prior opinions of the Accounting Principles Board, and bulletins of the Committee on Accounting Procedure and other letters are in various stages of preparation.

A Statement of Position on Recognition of Profit on Sales of Receivables With Recourse was published on June 14, 1974 as a recommendation to the FASB for development of an accounting standard. The statement takes the position that a uniform accounting approach is desirable for the recognition of profit or loss on sales of receivables with recourse and that the "delayed recognition" method rather than the "immediate recognition" method is preferable. An example of the type of transaction considered is the endorsement fee charged by Mobile Home Retailers when the customer finances the purchase price with the retailer.

The committee's agenda covers many current accounting problems, but only a few will be mentioned now. The first draft of a Statement of Position on Presentation and Disclosure Standards for Financial Forecasts has been completed. When this document is finalized, it will be submitted to the FASB and will be available to members of the AICPA. A recommendation to the FASB for development of an accounting standard on revenue recognition when a right of return exists is in process. Another project for ultimate referral to the FASB is an analysis (without conclusions) of the major issues regarding real estate investment trusts.

AICPA — Auditing Standards Division Executive Committee

This Committee (AudSEC) issues pronouncements on auditing standards and procedures. These procedures are enforceable under the AICPA Code of Professional Ethics.

You will recall that Statements on Auditing Procedure Nos. 33 through 54 were codified in Statement on Auditing Standards No. 1 published in 1973. Since then exposure drafts of two proposed Statements on Auditing Standards have been issued for comment from interested persons.

An exposure draft entitled "Reports on Audited Financial Statements" distributed in May 1974 represented a substantial revision of an earlier draft issued in August 1973. If adopted in its present form:

- A "subject to" opinion will be the accepted means of expressing an auditor's reservations arising from the outcome of uncertainties; however, an auditor will not be precluded from disclaiming an opinion.
- A separate explanatory paragraph will be required if the auditor's opinion is qualified or adverse, or if an opinion is disclaimed.
- Piecemeal opinions will no longer be appropriate for use.
- When financial statements for the current year are accompanied by those for the prior year, the auditor will be expected to report on both years if both have been examined.

These proposals, if adopted, would be effective for reports on financial statements for periods ending on or after December 31, 1974, except the prohibition of piecemeal opinions would be effective for reports on financial statements for periods ending on or after January 31, 1975.

The initial exposure draft on the second proposed standard entitled "The Effects of Electronic Data Processing on the Auditor's Study and Evaluation of Internal Control" was mailed at the end of July 1974. The need for an auditor to understand an entire computer system sufficiently to evaluate its essential accounting control features is emphasized. The use of computers in recording data influences the manner in which an auditor reviews and evaluates the internal controls over the process. The auditor's choices regarding reliance on various controls within an EDP system are outlined and alternative actions including non-computer controls when a system is inadequate are suggested. While recognizing the EDP systems can be changed without visible evidence, permitting the recording of spurious records and unauthorized transactions, the exposure draft also acknowledges that the use of a computer system often provides an opportunity to improve accounting control of recorded transactions since it is not subject to errors caused by fatigue or carelessness, and it processes like transactions in a like manner.

Some of the other subjects on the committee's agenda include:

- Reporting on forecasts.
- Recommended procedures regarding use of financial statement data outside of the financial statements and related notes in documents such as annual reports.
- Development of procedures to determine the existence of transactions with related parties.
- Reporting on and association with interim financial statements.
- Audit supervision
  - Considerations of a CPA firm in maintaining the quality of its auditing practice.
  - Guidance to the supervisory members of an audit team in the field in applying the first generally accepted auditing standard of field work.
- Use of the work of a person skilled in a discipline other than accounting by an auditor in forming an opinion on financial statements.
- Using the work of internal auditors.
- Reporting on price-level financial information.
- Reporting on common trust funds.
- Determination of reporting requirements which should be followed between the points in time when the FASB pronouncements identify a standard and its effective date.

FASB — An Update

The FASB is diligently pursuing its announced agenda and flooding the mails with its discussion memoranda and exposure drafts. Before considering the contents of these memoranda and drafts, a brief review of the procedures usually preceding issuance of a Statement of Financial Accounting Standards might be in order. A task force is chosen which defines the problem, determines the nature and extent of research to be done, and prepares a discussion memorandum outlining alternative solutions without stating any conclusion. A public hearing takes place 60 days after distribution of the discussion memorandum. Next, an exposure draft based on the papers submitted and testimony at the public hearing is prepared and distributed for comments from interested parties. Then following evaluation of the comments received on the exposure draft, a Statement of Financial Accounting Standards is prepared and, if voted upon affirmatively by five of the seven FASB members, it is issued.

After distribution of a discussion memorandum covering research and development and similar costs as related to both operating companies and companies in the development stage in December 1973 and a public hearing in March 1974, two exposure drafts were issued.

The first draft was a proposed statement relating only to research and development costs of operating companies. It was distributed on June 5, 1974 and comments were requested by August 5, 1974. The research and development costs included under this proposed standard would consist of:

a. materials, equipment and facilities,
b. personnel,
c. intangibles purchased from others,
d. contract services and
e. indirect costs, but not general and administrative costs which are not directly related to the research and development activities.

Only costs related to research activities aimed at discovery of new knowledge which it is hoped would be commercially useful and the translation of such research findings into new or improved products, processes or services capable of commercialization, including prototype and pilot operations, would be considered research and development costs. All research and development costs not directly reimburseable by outside parties would be charged to operations when incurred and the amount included in expense during the period would be disclosed in the financial statements. If adopted, the provisions of this Statement would be effective for all research and development costs incurred during fiscal years beginning on or after January 1, 1975. Any deferred research and development costs incurred prior to that date would be written off as a prior period adjustment.

A second exposure draft entitled "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components" was issued July 19, 1974 and comments were requested by September 30, 1974. The FASB has concluded that companies in the development stage require no special accounting standards. The Statement, if adopted, would require entities in the development stage to

a. charge to expense as incurred during the development stage those costs which would be charged to expense as incurred when the entity is no longer in the development stage,
b. capitalize or defer only those types of costs which may be capitalized or defer-

red subsequent to the development stage,

c. report sales of goods or services, interest or other income as revenue in the income statement,

d. assign dollar amounts to shares issued for non-cash consideration, and to the consideration (asset or service) received, at the time of issuance of the shares, and

e. report cumulative net losses as "accumulated deficit" in the stockholders' equity section of the balance sheet. The primary financial statements would be

1. a balance sheet,

2. an income statement showing cumulative amounts from inception as well as amounts for the period,

3. a statement of changes in financial position showing cumulative and period amounts, and

4. a statement of owners' investment showing each issuance since inception.

Presently development stage companies usually present statements of assets and unrecovered development costs, liabilities, capital shares, and receipts and disbursements. The Statement, of course, does not consider the auditors' problems in reporting upon the statements proposed. Guidelines for identifying an entity in the development stage are included in the statement. The effective date and provision for prior-period write-off are the same as in the statement on research and development costs. An additional exposure draft on "similar costs" such as market research, promotion, training and relocation and rearrangement is currently being considered by the FASB.

Other projects on the agenda for which discussion memoranda have been distributed and public hearings have either taken place or have been scheduled are:

- *Reporting the effects of general price-level changes in financial statements:*
  The basic question is "should reporting of the effects of general price-level changes be required as supplemental information to the conventional historical-dollar financial statements?" It was pointed out that restatements of accounting information for changes in the general level of prices does not measure the "current value" of a company's assets and liabilities. Price-level restatement is based on historical costs adjusted by use of an index of the general purchasing power of the dollar.

- *Accounting for foreign currency translation.*
  The three basic questions involved here are
  a. determination of the objective of translation — whether the objective is still expression of foreign currency amounts in terms of U.S. dollars as if the foreign currency transactions had been executed in dollars,
  b. determination of which of the assets and liabilities of foreign entities should be adjusted for changes in exchange rates, and
  c. determination of the nature of an exchange adjustment — a gain or loss or an adjustment of other accounts.

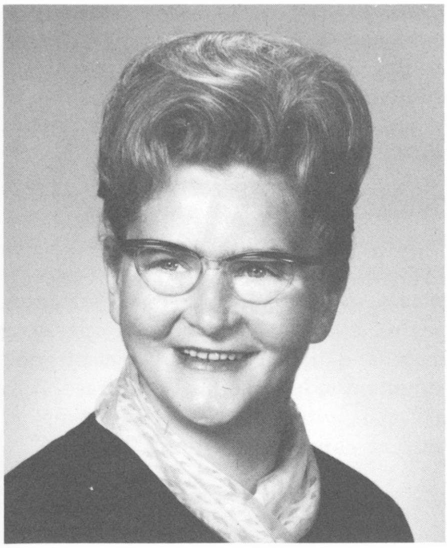
- *Accounting for future losses.*
  Four possible criteria for accrual of future losses, such as self-insured losses and losses from expropriations by foreign governments, are listed in the discussion memorandum. These are
  a. there is an existing condition or set of circumstances that may result in a loss,
  b. the occurrence of the loss is sufficiently predictable,
  c. the loss is properly chargeable to current revenues or is reasonably related to the operations of the current period or a prior period, and
  d. the loss can be measured with reasonable approximation.

- *Financial reporting for segments of a business enterprise.*
  The major question here is whether information about segments of a business enterprise should be included in financial statements and, if it should, what information should be included and how it should be presented. Also discussed in the memorandum are the approach to be taken in specifying the segments (organizational, such as divisions, branches or subsidiaries; or economic activity, such as industries, product lines, markets or geographical areas), whether common costs which are not traceable to individual segments should be allocated and, if so, on what basis, and whether intersegment transfers should be included in segment sales and, if so, how they should be priced.

- *Conceptual framework for accounting and reporting.*
  The discussion memorandum is based almost exclusively upon the report of the Study Group on the Objectives of Financial Statements, commonly known as the Trueblood Report. Consideration of the 12 proposed objectives of the Trueblood Report are the initial step in the FASB's ongoing project on the entire conceptual framework of accounting and reporting, including objectives, qualitative characteristics and the need of users of accounting information.

- *Accounting for leases.*
  The principal aspects of accounting and reporting for leases by lessees and lessors, including "leveraged leases", are discussed in the memorandum. It also compares and analyzes the arguments for and against capitalizing various types of leases by lessees and discusses different viewpoints as to what information should be included in notes to the financial statements.

Task forces have been appointed for the last two items on the agenda which are Criteria for Determining Materiality and Business Combinations and Related Intangibles. Materiality seems always to be an illusive concept; however, the stated aim of this project is a definition of the standard of materiality and criteria for its application. Even determination of the method of attacking the project on business combinations apparently presented a problem to the FASB. In April 1974 it was announced that there was great need for immediate action on the existing criteria for pooling of interests accounting and that that subject would be considered first. Then in June 1974 the FASB announced that it had decided to drop consideration of the criteria and concentrate on a total reconsideration of *Accounting Principles Board Opinions No. 16* and *17*. Basic questions will be whether the pooling of interests method is appropriate under any circumstances and the treatment of "goodwill". Considering the many years of controversy over business combinations before the APB issued its opinions and the fact that the AICPA has issued 39 interpretations of *APB No. 16*, most of which related to application of the criteria, and that the Securities and Exchange Commission has issued three Accounting Series Releases relating to the criteria, watching the steps in the development of an accounting standard by the FASB on this subject should be fascinating.



Small Business

Personnel acquisitions — Where it all starts

Barbara I. Rausch, CPA
Marysville, Ohio

While the labor problems of "big business" with union-negotiated programs — often under the threat of strike or imminent walk-out — hit the headlines, small business has personnel problems that are every bit as serious and perhaps more crucial to the continued success and even continued existence of the enterprise.

Despite the fact that we are going through a period of high unemployment, we are faced with a critical shortage of skilled people. More often than not a call to the local unemployment office turns up everything but what the employer is looking for. Our affluent society has placed ever-increasing emphasis on formal education and preparation for professional careers, and the training of people for the skilled trades has been left largely to the trade unions — which does not help small business a bit. Now, many states have established branches of their state-supported colleges which teach technical and vocational skills. But the gap, though narrowing, will exist for some time to come.

On the bright side of the coin small business is more flexible than big business, and at times it may be possible to narrow or broaden the scope of a job opening to fit applicants if otherwise they appear to be the type that would be a desirable addition to the personnel staff.

What type job

Probably the most important thing to do when looking for a new addition or a replacement in the personnel area is for the person in charge of the department who will conduct the interviews to make a truly honest appraisal of the job that needs filling.

Nobody likes to look at a dead-end job, but if under present conditions the job shows very little possibility for upgrading and if it does not look like a stepping stone to better opportunities, the person in charge of conducting the interviews better realize it and select somebody who will be satisfied with the limitations of the position. And there are people like that.

On the other hand, if the opening has all the earmarks of a great opportunity for the right person, management should look for all the talent and ambition money can buy.

Permanency and training requirements are very important considerations. If the job opening is for a position which will probably be phased out in two or three years, the most desirable applicant may be a person that appears suitable for another position beyond the scope of the present vacancy, a position that may only be in the planning stage at this time. Or a person who will reach normal retirement age by the time the job is slated for abandonment can be found.

The time it takes to train a person for a parcitular job should have a direct relationship to the length of time the new employee stays on the job. It does not always work out that way, but careful planning can at least reduce the cost of personnel turn-over in highly specialized jobs with long training periods. It can be not only costly but also very frustrating if a business finds itself the training ground for its competitors. A routine job that most anybody with adequate education and experience background can pick up and "fill" satisfactorily certainly does not require the same kind of screening effort.

This soul-searching on the part of the interviewer cannot be overemphasized. The chances of getting exactly the right person for the job opening are rather small. Therefore, before advertisements are placed or employment agencies are contacted, a decision should be made what to do with the overqualified and the underqualified, the experienced and the inexperienced applicant. The subject of overqualification has been discussed from every possible angle. Many companies, especially the larger ones, have a definite policy against hiring overqualified people. That may be rather short-sighted for the small business. Who knows whether this applicant won't open new doors for the business and what opportunities may arise a few years down the road. Only the stagnant business with closed-minded management has no use for the over-qualified. As for the underqualified, the training facilities of the company will have to be evaluated rather carefully to see whether the applicant can be brought up to the requirements of the job and whether the amount of time and money it will take will be worth it. One danger here might be that, once trained, the employee might seek greener pastures.

There can be no question about the fact that experience costs money — one way or the other. Hiring an experienced person will be more costly right from the start, but it may cost more to let the new employee gather the necessary experience in the employ of the company!

By the same token, experience has to be

exactly what the business needs. For instance, a salesperson who has raked up tremendous volumes (and makes very good money) in selling large quantities of low-price items may be completely worthless in the sale of high-price items, such as cars, real estate or home improvements. The same careful evaluation of experience is indicated for skilled trade jobs. Is a plumber a plumber or is the business in need of a specially trained plumber? Or in the administrative area, is a bookkeeper a bookkeeper or will the company's equipment be more than what he or she can cope with?

The Work Climate

The importance of personality-matching decreases in proportion to the number of people involved. Two people who have to work together and cannot stand each other are a disaster, while a team of ten might be able to afford a personality "misfit". With a small group of employees there is usually only one leader who sets the atmosphere, accepts or rejects newcomers and generally "runs the show". A very strong newcomer, personality-wise, may challenge the existing pecking order, can create turmoil and adversely affect productivity. But, then again, it may be desirable to establish a new order. However, if everything is running smoothly, the interviewer will have to try to match personalities as well as ability.

Meeting of the Minds

All this careful preparation for interviewing new applicants will have been wasted if the interviews are not conducted with complete candor. This, of course, is a two-way street, and it pays to be wary of the evasive applicant and probably of the over-confident one, too. From the applicants' point of view (of course depending on the type of opening) they are entitled to know at the outset whether there will be "room at the top", what the job entails, where it may lead, what the company expects and what they can expect of the company. A true meeting of the minds is very important and can prevent the loss of a desirable employee later on. This can be particularly important with the applicant who is considered overqualified for the present job. The interviewer should point this out and candidly discuss whether the applicant can expect advancement and, if so, when and how.

The practice of hiring on probation has a lot to recommend it. If the applicants are confident of their ability and have confidence in the fairness and integrity of the company, they should not object. This practice gives the company the opportunity to let go a new employee who does not work out without formal release procedures and too much explanation. Psychologically, it is a hard thing to tell a person that he or she does not measure up, and a release at the end or during a period of probation is much easier to handle.

Whenever all else fails, "lack of communication" makes a good reason for any failure. But it can be truthfully said that a less than candid employment interview is at the root of most instances where employees are unhappy or employers are dissatisfied with their employees.

The Government's Role in Employment Decisions

Management knows, and interviewers need to remind themselves, that the hourly, weekly or monthly compensation the company agrees to pay is not the true cost of payroll. Generally speaking, it is much higher. There are 5.85% F.I.C.A. contributions, up to 5% state and federal unemployment contributions and either state insurance funded Workmen's Compensation or mandatory commercial insurance which can run as high as 10%. In addition, many companies have fringe benefit programs, such as paying the hospitalization insurance for their employees, and a large number of small business firms have profit-sharing or pension plans. With the Pension Reform Bill now in Congress, participation and vesting requirements will be tightened quite a bit, and where employers used to have three to five years waiting periods, they will now have to decide in one year whether an employee should become a permanent.

But today the true cost of payroll may also be less than the agreed-upon rate of pay. The Work Incentive Program enacted by Congress allows a tax credit of up to 20% of the wages paid an employee certified by the Secretary of Labor as having been placed in employment under a WIN program, provided he or she does not displace another individual from employment. This credit applies to wages paid for the first twelve months of employment which do not need to be consecutive so long as they are paid within twenty-four months from the date of first employment. This makes it possible to have seasonal employees under the WIN program.

The total cost of payroll should also be considered in making the decision whether to hire part-time and/or seasonal employees or to use one of the many services who provide employees for any length of time from a few hours to a steady vacation stand-by. Of course, these agencies bear all payroll tax costs and usually do not ask any questions if the user of their services indicates either positive or negative preferences regarding any of their employees.

Conclusion

No question about it . . . personnel management is one of the most important aspects of small business. In many instances payroll is a large part of total operating costs, and it takes a great deal of good judgment to handle this vital phase. And it all starts with the time and effort that go into personnel acquisitions.

Pooling of Interests vs. Purchase Effects on EPS

(Continued from page 11)

While it is not the purpose of this study to delve into the uses of accounting data by readers of financial statements, it can be said that a reader relying solely on reported data may in fact be relying on illusory earnings created by application of selected accounting rules.

Footnotes

[1]Samuel P. Gunther, "Lingering Pooling Problems," *The CPA Journal* (June 1973) pp. 459-464.

[2]e.g., Henry R. Jaenicke, "Managements' Choice to Purchase of Pool," *The Accounting Review*, XXXVII (October 1962) pp. 758-65; and Samuel R. Sapienza, "Business Combinations—a Case Study," *The Accounting Review*, XXXVIII (January 1963) pp. 91-101.

[3]U.S. Bureau of Economics, Federal Trade Commission, *Large Mergers in Manufacturing and Mining 1948 - 1970*. Statistical Report No. 7 (March 1971), Publication number R 6-15-9.

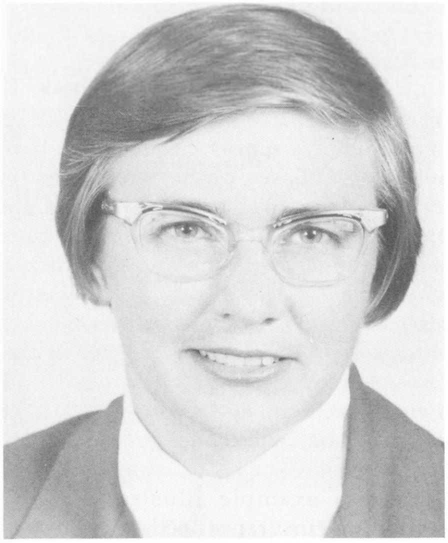
[4]All information derived from published *Annual Reports, Compustat Tapes, Moody's Industrial Manual, and Listing Application to New York Stock Exchange.*

[5]In one instance the data necessary for analysis is unavailable. The companies involved refuse to provide annual reports and the library sources fail to provide the necessary data.

[6]EPS_t are earnings per share as reported by the acquiring company in the year (time period) of the merger.

[7]Richard W. McEnally, *The "Information Effect" and Price-Earnings Ratios*, (unpublished Working Paper 69-8, The University of Texas at Austin, 1968) p. 13.

[8]Ronald M. Copeland and Joseph F. Wojdak, "Income Manipulation and the Purchase-Pooling Choice," say that "the results strongly support the hypothesis that firms record mergers by the method that maximized reported income." In *Journal of Accounting Research*, Vol. 7 (Autumn 1969), p. 195.



Personal Management

Life and Disability Insurance

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There are several reasons why a professional person would want life and disability insurance. This article will discuss the situations in which insurance is advisable and also present some of the alternatives available when selecting insurance.

Life Insurance

One of the basic reasons for buying life insurance is to provide for dependents. This includes care for a spouse, children, parents or the aid you may wish to offer your nieces and nephews to help them through college.

Life insurance is also a good source of funds for business buy-outs. A business buy-out agreement is often used when two or more people form a partnership or corporation and desire that the surviving partner(s) or shareholder(s) be permitted to continue the business. If the principle purpose is to continue the business, each individual should purchase life insurance on the life of the other(s). When one dies, the other(s) collects the life insurance proceeds, which are then used to purchase the deceased partner's or shareholder's interest from the estate or heirs.

Many estates are composed almost entirely of non-liquid assets such as real estate. These non-liquid assets may have to be sold quickly to provide cash to pay estate taxes. If the market is depressed at the time, value could be lost by making a quick sale. In this situation, life insurance would be valuable in that it could provide cash to pay the taxes. You may find it appropriate for your beneficiaries to own the life insurance and use the proceeds to buy the non-liquid assets from your estate. This would get cash into the estate to pay the taxes and get the estate assets to the beneficiaries; it would also keep the insurance proceeds from being taxed in the estate.

Life insurance would also be valuable if you have a charitable organization you would like to help. Most colleges and universities will send you information about naming them as beneficiaries.

Disability Insurance

Disability insurance is a must for the person who relies on a salary. A prolonged illness can cause the salary to stop and leave the independent wage earner dependent on someone else for the necessities of life. Disability insurance can fill that gap by providing cash for living expenses during a prolonged illness.

Consequently, for the single person without dependents disability insurance becomes more important than life insurance. The disability insurance should be integrated with any wage continuation program provided by an employer. Social security benefits which could become available should also be considered when determining the amount of proceeds necessary.

Example

As an example of the considerations involved in determining an individual's insurance coverage, the following situation was presented to Joseph M. Berwanger, CLU of Columbus, Ohio, to evaluate the individual's insurance needs.

Marion Smith is 35 years old and is the proprietor of an accounting business which nets approximately $20,000 per year. Marion's assets and liabilities are as shown in Chart 1.

Chart 1

	Cost	Market Value
Assets		
Cash	$ 5,000	$ 5,000
Receivables	- 0 -	10,000
Rental Property	60,000	100,000
Residence	25,000	49,000
Automobile and Personal Effects	15,000	8,000
Total Assets	$105,000	$172,000
Liabilities		
Mortgage on Rental Property		55,000
Mortgage on Residence		15,000
Total Liabilities		70,000
Excess of Assets over Liabilities		$102,000

Marion's parents are living; both are retired and may need financial assistance from Marion in the future.

Mr. Berwanger presented the following insurance plan for Marion:

> With Marion's family consisting only of her parents there is probably no need for insurance payable to them. Their expected future need of financial assistance can be provided through rental income from Marion's real estate holdings.
>
> Her business will not need life insurance at this time. However, if she brings in a partner, she may want some type of funded partnership agreement to acquire the interest of the deceased partner.
>
> Her estate should be looked at from the standpoint of liquidity needs. There should be enough cash in the estate for burial expenses and any medical bills not covered by insurance. But money will be needed for other estate costs. Chart 2 is a breakdown of estimated estate costs should Marion die in the near future.

Chart 2

Gross Estate		$172,000
Administration Expense		
(4% of $172,000)	6880	
Debts Against the Estate	70,000	
Total Administration Expenses		
& Debts		−76,880
Adjusted Gross Estate		$ 95,120
Less Personal Exemption		60,000
Net Taxable Estate		$ 35,120
Tax Payable (Less State		
Death Tax Credit		3,900
State Death Tax Payable		
(Ohio Rates)		2,150
Total Cash Requirements ..		$ 12,930

In addition to this cash need of $12,930 are the mortgages on the real property. If Marion dies after the mortgages are paid off, the adjusted gross estate will be higher, and the estate taxes will amount to $33,280. But if she dies before the mortgages are paid off, her parents might find it difficult to refinance the properties due to their advanced age. Therefore, Marion should consider $30,000 of permanent insurance (whole life) to solve the permanent problem of estate liquidity. The balance of her mortgage obligations should be insured with mortgage insurance.

Chart 3

Today's Need's

Estate	$12,930
Mortgages	70,000
Total — Insurance Need	82,930
Whole Life	30,000
Mortgage Insurance	$52,930

Mortgage coverage of $48,000 can be added to the $30,000 whole life insurance as a rider at an added premium of $124.25 annually. The total annual premium of $798.25 can be paid in monthly installments of $68.17. As the table below shows, the cash value rapidly equals the net premium. Marion can therefore pay the premiums under a minimum deposit basis. She should be sure to pay four premiums of the first seven — see No. 264 I.R.C.

More and more people are using insurance now to help their churches or schools. The premiums are generally deductible for income tax purposes, and the insurance proceeds provide needed cash for such organizations.

Marion must keep an eye on her estate. Her acquisition of additional non-liquid assets could increase her estate costs at a tremendous rate due to her lack of the marital deduction.

Marion has an obvious need for disability coverage. If she is unable to work due to an injury or illness, her income obviously stops. Based on her present earnings her personal needs per month are probably about $1,100. She should consider a 60-day waiting period, during which her accounts receivable would carry her, sickness payments for 5 years (after 2 years of sickness in 99% of the cases people are either well or dead), and lifetime accident insurance. The cost of this on a non-cancellable, guaranteed renewable basis is $334.62 annually.

As this example illustrates, each individual's insurance needs vary according to the particular situation. This article was intended merely to help you evaluate whether you need life and/or disability insurance.

Selecting an agent is very important. A very large percent of the agents leave within two years. Since insurance is very complex, it normally takes several years for an agent to thoroughly learn the business so that he will be an effective counselor. Be sure to select an agent who will be receptive to your needs and will help you select the insurance which best fits your situation.

Chart 4

$30,000 Whole Life

Year	Dividend	Net Premium	Cash Value Increase	Yearly Net Cost
1	—	674	162	512
2	72	602	548	54
3	89	585	559	26
4	105	569	568	1
5	121	553	578	(25)
10	225	449	547	(98)
20	372	302	611	(309)

Reviews

Writings in Accounting

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Memphis, Tennessee

THE GREAT WALL STREET SCANDAL (INSIDE EQUITY FUNDING), Raymond L. Dirks and Leonard Gross; McGraw-Hill Book Company, New York, N.Y., 1974; 295 pages.

Written as a documentary narrative history *The Great Wall Street Scandal* is presented as the inside story of the Equity Funding hoax — the most monumental money swindle of modern times. Dirks, an unconventional stockbroker, and Gross, a ranking journalist, assert that this is more than a story about a $2 billion insurance fraud. They view it as a metaphor of the moral corrosion in America's business and institutional environment.

Although the book cannot be considered a great literary work, it is of considerable interest for what it chronicles with the startling ring of truth. Having followed the Equity Funding story with interest, this reviewer was nevertheless revolted and appalled by the detailed documentation of avarice, greed, cupidity, and dishonesty which characterized the actions of individuals in top management of the company. As the authors state, however, what is ultimately more shocking is the number of decent people who knew about it and did nothing. The authors conclude that a major factor in the cover-up was the inertia of the various spectators and casual participants.

This book should be read through as quickly as possible. The cast of characters is large, but with the helpful listing of them in their order of appearance at the beginning of the book it is possible to keep up with all of them.

The authors discuss several questions which are raised by the Equity Funding case: lax and haphazard governmental regulation; life insurance as an appropriate means of saving for the American investor; fraud by computer; the New York Stock Exchange as a venerated American institution which, in their opinion, is antique, costly, dangerous, and perpetuated for the convenience of its members; the allegedly pernicious philosophy of Wall Street which, they think, encourages and even demands "performance" by corporations; and the system by which American corporations are audited.

Of special interest to the accounting profession is that, according to the authors, the Equity Funding scandal indicates that audited statements are not always what they appear to be. In their opinion this scandal tells American stockholders that the certification of corporate figures in the annual reports may very well be meaningless. The authors further assert that the investigators in the case agree that the fraud could not have been carried off for so long without the assistance of the company's auditors. They finally claim that auditors as safeguards are worthless.

In the final two chapters the authors take up the questions they raised and come up with some "out-of-court indictment" and the assertion that the individual investor is not adequately protected by the securities markets, brokers, analysts, auditors, or regulators. Their "bottom line" conclusions are that this repellent event provides lessons galore: underwriters scrutinized the books; bankers made analyses for lending purposes; lawyers prepared prospectuses; consulting actuaries certified insurance reserves; the auditors blessed the books — and yet "every last one of them failed," they think.

This is not a reassuring book. It is not pleasant or relaxing reading. It makes damaging (and convincing) assertions regarding our traditional institutions and the damage done to them by conscienceless individuals who feel they do not have to live by the rule of law. Importantly, it presents several challenges of immediate and vital concern to auditors and accountants reading this book.

Dr. Kathryn C. Buckner, CPA
Georgia State University

(Continued on pages 22 and 29)

Legal Developments

Affirmative Action and Reverse Discrimination: *THE DEFUNIS Case*

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Various affirmative action programs around the country are not being met with praise or accolade by a growing number of people affected by them. In many cases people simply do not understand what affirmative action really is. Some people are absolutely convinced that it is a quota system that forces universities and business firms to hire incompetent women and minorities. While this belief is mistaken, it may have a solid basis as a result of the way some affirmative action plans are applied or perceived by those trying to implement them.

Affirmative Action

"Affirmative Action" is a concept begun and promoted by the Department of Health, Education and Welfare (HEW) and the Office of Economic Opportunity (OEO). The basic purpose of affirmative action is to lower traditional barriers against women and minorities in higher paying and status jobs. The statistical data clearly shows that women and minorities have been, and are now, clustered in the lower positions in the universities. (E.g., there are very few women who are full professors and most women are lecturers, instructors, or assistant professors. This is true even where educational degrees, publications and other qualifications are equal to men's who are associate and full professors.) Affirmative action was begun to remedy this situation. It does not require universities to "hire any but the most qualified people."[1] What it does require is that universities conduct a diligent search for *qualified* women and minorities and to have documented proof of that search. It is not a quota system and it does not require that unqualified people be promoted. It merely attempts to insure that women and minorities are given equal scrutiny for faculty positions. For example, in the University of Washington's affirmative action plan (which is in excess of 200 pages, excluding appendices), nowhere does it state a quota and there is not one single reference to giving preference to unqualified women or minorities. It simply says that persons who are hiring must make a diligent search to find qualified women and minorities to fill the appropriate positions.

Unfortunately, there is a definite backlash. Employers and supervisors are complaining that there are not enough qualified women and minorities so they are being forced to hire incompetent women and blacks. Women who attained high positions before affirmative action feel that their efforts and status are being downgraded because their superiors and colleagues think that any woman in a high position is there because she is a woman, not because of her efforts, qualifications or competency. The people who are hired under affirmative action are meeting with resistance and discrimination by superiors who are convinced that they are "quota bums". But amid all this grumbling one major theme seems to emerge: people will be glad to hire and promote qualified people whether they are female, black or any other minority group. (This contention, on the part of some, is a sincere one; for others, it appears to be lip service.) Even the most strident opponents of affirmative action suggest that more "appropriate emphases [be put upon] increasing the supply of well-prepared women and blacks with doctoral degrees."[2] One must come to the conclusion, then, that education is the key to raising the status of women and minorities. A recent Supreme Court case examined this problem when it heard a reverse discrimination case of a white male denied entrance to law school.

The DeFunis Case[3]

In 1971 Marco DeFunis, a white male, applied for admission to the University of Washington School of Law. That year the University of Washington Law School received 1601 applications for admission for about 150 available spaces. In order to fill these spaces, 275 applicants were offered admission. Thirty seven of those offered admission were minorities and eighteen of them actually entered law school. DeFunis was not offered admission.

The U of W admissions process is based upon an index called the "Predicted First Year Average." This average is computed by a formula giving various weights to the applicant's grades in the last two years in college, the score obtained on the Law School Admissions Test (LSAT) and a Writing Test Score. That year the admissions committee (comprised of faculty, administration and students) decided that the most outstanding applicants were those who scored 77 or above. The highest score was 81. By August 1971, 147 applicants with averages of 77 or better had been offered admission. All but a few of the applicants with an average below 74.5 were eliminated. (The few who were not eliminated were saved for committee consideration on the basis of information in their files that indicated greater promise than was suggested by their averages.[4])

Finally, the committee accumulated those applications with scores between 74.5 and 77 for consideration. DeFunis was in this group with a score of 76.23. These applications were distributed randomly to the committee members who would consider the applications competitively, with rough guidelines as to how many could be admitted. The decisions were made on the basis of information in their files. After offering about 200 admissions, a waiting list was constructed and divided into four ranks. DeFunis was on this list in the lowest quarter. Ultimately, he was not offered admission.

Applications of blacks were handled differently. Whatever their averages, they were not passed on to the committee chairperson for rejection. Neither were these applications randomly distributed to committee members, they were instead given to two particular members: a black law student and a professor who had worked in a special program for disadvantaged students considering applying to law school. Other minority applications were assigned to an assistant dean. At no time were the minority applicants compared to the other applicants, but they were compared competitively with other minority applications. Thirty seven minority applicants were admitted, thirty six of whom had "Predicted First Year Averages" below DeFunis' average. (30 had averages below 74.5, meaning that, had they been white, they would have been rejected.) There were also 48 nonminority applicants admitted who had averages below DeFunis.[5] The University conceded that it placed less weight on black applicants' averages than upon those of white applicants. The Law School also stated that had the minority students been considered under the same procedure as other applicants, none of those who were eventually enrolled would have been admitted.[6]

DeFunis commenced suit in a Washington trial court, contending that "the procedures and criteria employed by the Law School Admissions Committee invidiously discriminated against him on account of his race in violation of the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution."[7] DeFunis brought suit on his own behalf (rather than as a class action suit) and asked the court to "issue a mandatory injunction commanding the respondents to admit him as a member of the first-year class entering in September of 1971, on the ground that the Law School admissions policy had resulted in the unconstitutional denial of his application for admission."[8] The lower court upheld his claim and he was admitted to the Law School in 1971. On appeal, the Washington Supreme Court reversed the lower court's verdict. DeFunis then petitioned the Supreme Court of the United States and the circuit judge "stayed the judgment of the Washington Supreme Court,"[9] pending the final Supreme Court decision.

The United States Supreme Court first considered his certiorari petition in the fall of 1973. Thus, DeFunis was in his last year of law school. Since it was not a class action suit, the case would have been rendered moot had the court not heard the case before DeFunis graduated. Neither DeFunis nor the University of Washington wanted the case dismissed as moot. The University of Washington indicated that "if the decision of the Washington Supreme Court were permitted to stand, the petitioner could complete the term for which he was then enrolled but would have to apply to the faculty for permission to continue in the school before he could register for another term."[10]

The case was finally argued on February 26, 1974 and the decision reached on April 23, 1974. By this time DeFunis had registered for his final quarter in law school.

The final decision of the Supreme Court was a disappointment to both the respondents and the petitioner as well as other people following the case. One writer said the justices "went mute by declaring the case moot, . . . [and wrangled] over why they should duck the case."[11] In a 5-4 decision, the Court declared the case moot and refused to consider the constitutional questions involved. The minority opinion (written by Mr. Justice Brennan) decided on the same narrow grounds as the majority, only the minority decided the case was not moot. In effect, then, the decision was a nondecision. The Justices bickered about whether or not there was some prospect that DeFunis would not graduate at the end of the quarter (and thus be required to re-apply) and the case was decided essentially on that point.

While some accused the Court of avoiding a painful decision and abrogating its duty, others felt there was no alternative for the Court. If they ruled against DeFunis, they would be advocating denial of constitutional rights. If they had ruled for DeFunis, there was some fear that all affirmative action plans would have been summarily abandoned by all universities. The Court may have to decide the issue because DeFunis (who has since graduated) is back in the Washington courts attempting to get the case changed to a class action suit.

Justice William O. Douglas was one of the dissenting minority but he felt so strongly about the case that he wrote a separate dissenting opinion.

The Dissenting Opinion

Justice Douglas took a rather historical approach in his lone dissenting opinion. He related how the philosophy in the early twentieth century was to allow each law student into school and prove him/herself in the first year. As spaces for students became more scarce, the pressure to use some sort of admissions test mounted. The LSAT was introduced in 1948 and has been the main common entrance criterion since then. He then proceeded to demolish its effectiveness by stating that the truly creative individual may do poorly on a "few hours' worth of multiple choice questions." He also raised the possibility of a cultural bias in the LSAT.[12] This contention has merit from other studies of other tests. For example, Robert Williams has developed the Black Intelligence Test of Cultural Homogeneity (the Bitch test) and has tested it on whites. To no one's real surprise, whites do quite poorly because the test measures whites' knowledge of the black experience (presumably the opposite of existing white-oriented I.Q. tests.)[13]

Justice Douglas next attacked the validity of prior college scores. He pointed out the obvious: that one school's "A" is another's "C" (which renders the grade point average, GPA, meaningless), and that since the late 1960's the average of all college grades has risen dramatically (presumably because of the Viet Nam War when a failing student might be drafted and because of a general raising of social consciousness about racial discrimination). As one author noted, these higher grades "infalted the students' grade point average and presented the law school with nearly meaningless data on which to predict the minority's chances at successfully surviving the rigors of law study."[14] Further, "there is no clear evidence that the LSAT and GPA provide particularly good evaluators of the intrinsic or enriched ability of an individual to perform as a law student or lawyer in a functioning society undergoing change. Nor is there any clear evidence that grades and other evaluators of law school performance, and the bar examination are particularly good predictors of competence or success as a lawyer."[15]

Finally, Justice Douglas noted that GPA and LSAT do not measure relative progress or motivation. A ghetto black who rises to a junior college has made more progress than, say, a Harvard student from an affluent (Harvard-educated) family. "Because of the weight of the prior handicaps, that black applicant may not realize his [sic] full potential in the first year of law school, or even in the full three years, but in the long pull of a legal career his [sic] achievements may far outstrip those of his [sic] classmates whose earlier records appeared superior by conventional criteria."[16]

Justice Douglas' conclusion was that, under the Fourteenth Amendment, "separate treatment of minorities as a class is to make more certain that racial factors do not militate *against an applicant or on his* [sic] *behalf.*"[17] He, therefore, would have upheld the University of Washington's Affirmative Action Plan and separate admission procedures for minorities.

The Aftermath and Applicability of DeFunis

The furor and indecision witnessed in Seattle and at the University of Washington as a result of the *DeFunis* case is interesting. The Law School is uncertain as to what to do (pending the outcome of Marco DeFunis' attempt to have the suit declared a class action one) so they are continuing their existing policies. Others are "choosing up sides." On the one hand, the liberals are pointing out that education itself has always been discriminatory: the affluent produce children who become affluent; alumni's children get preferential treatment; society's goals should not be to educate an elite few but to even out past injustices; and, anyway, there has always been discrimination (at taxpayer's expense) in favor of athletes, etc.

On the other hand, the other side is gathering substantive data supporting the view that the Law School should not use two admission policies. In a nutshell, "the law school has proportionally more minority students flunking out now than was the case five years ago, and no one is sure why."[18] The Law School is reacting by providing special re-admission (or retention) procedures for minority students who flunk courses and by providing special tutoring services for minorities.[19] Opponents are pointing out that "of the first group of 13 specially admitted minorities to take the bar [exam] last year, 10 passed. That's a passing ratio directly comparable to white students."[20]

In all of this activity, not one word has been said about women law students. However, the women's legal students' organization is becoming more verbal, pointing out that they, too, are a minority. As it stands, the University of Washington Law School uses exactly the same criteria for admitting women as it does white men (presumably on the premise that white women have roughly the same cultural biases as white men and, therefore, no special tests or admission policies need be applied).

Conclusion

While the decision in *DeFunis* was disappointing and did not result in definitive guidelines for affirmative action programs, it was of interest in its effects. Many are hoping that DeFunis is successful in his bid to change his suite to a class action one so that the Supreme Court of the United States will make a definite ruling in the future. Until then, each university must stumble along doing the best it can with existing affirmative action plans.

Footnotes

1Dr. John R. Hogness, quoted by Gene I. Maeroff, "Faculty Quota Quandry" *The New York Times*, reprinted in the *Seattle Post Intelligencer*, Wednesday, May 15, 1974, p. A-10.

2Dr. Richard A. Lester, *Report of Carnegie Commission on Higher Education*, to be published by McGraw-Hill this fall. This study concluded that affirmative action is undermining faculty quality because some programs "fail to take into consideration either the inadequate supply of qualified people among those groups currently underrepresented on our faculties or the characteristics of academic employment that distinguish it from employment in industry." It is amusing that the study had no pre-affirmative action studies of faculty quality with which to make a comparison of post-affirmative action faculty quality, yet it could conclude that the quality has decreased!

3*Marco DeFunis et al., V. Charles Odegaard, President of the University of Washington*, U.S. Supreme Court no. 73-235, April 23, 1974.

4*op. cit.*, p. B2428

5*op. cit.*, p. B2431

6*op. cit.*, p. B2432

7*op. cit.*, p. B2415

8*op. cit.*, p. B2415 and 2416

9*ibid.*

10*ibid.*

11Nicholas VonHoffman, "Discrimination in Reverse," *Seattle Post Intelligencer*, Tuesday, May 14, 1974, p. A-11.

12*Marco DeFunis, et al., op. cit.*, p. B2434.

13See "Try the SOB Test," *Psychology Today*, May 1974, p. 101. The author of the article took the exam and she scored very poorly, although on "normal" (i.e., White) I.Q. tests she scores quite highly.

14Solveig Torvik, "Righting Social Wrongs Worries Law Schools, "*The Seattle Post Intelligencer," Sunday, May 26, 1974, p. A-11.*

15*DeFunis, op. cit.*, p. B2436

16*op. cit.*, p. B2437

17*op. cit.*, p. B2442

18Torvik, *loc. cit.*

19"Dean to Rule on Student Failures," *The Seattle Post Intelligencer*, Wednesday, May 22, 1974, p. A-8

20Torvik, *loc. cit.*

Reviews

(Continued from page 19)

ACCOUNTANCY AND ECONOMIC DEVELOPMENT POLICY, Dr. Adolf J. H. Enthoven; American Elsevier Publishing Company, Inc., New York, N.Y., 1973; 380 pages, paperback.

The author's experience in public accounting, academia, and with the World Bank leads him to believe that accounting is not serving its broader purposes. He visualizes that accounting should extend horizontally — i.e., report and measure economic data of business, government, and social accounting areas; vertically — i.e., value costs and benefits for indirectly related items in addition to the directly related items which are now reported; and in time — i.e., report prospective activities necessary to provide a framework for decision making. His hope is that countries may someday be able to consolidate corporate figures into sector figures and into national figures. From the point of view of the World Bank, this would enable better assessment of a developing country's present stance and its economic potential. Present handicaps are lack of any accounting in certain segments of some countries and the wide differences in accounting as it is practiced in some of the developed countries.

The book is very readable. Sentences are simple and one hardly notices that English is not the author's native tongue. Some chapters deal with national income accounting, and this may be somewhat unfamiliar to accountants more used to dealing with micro-economic reporting. However, chapters on taxation and accounting, uniform or standardized accounting, current value accounting and PPBS (planning-programming-budgeting systems) are familiar topics.

One may not agree with all Dr. Enthoven proposes. Some of his conclusions (current value, prospective information) are not too far removed from certain aspects of the Trueblood report. He encourages coordination and integration of the accounting discipline with other disciplines, especially economics. He also hopes it will become more goal-oriented.

In addition, his writings contain information about systems and societies in other countries — extremely valuable information for accountants in a world which is steadily shrinking and becoming more internationally minded.

M.E.D.

Financial Statements

Forecasting Quantitative Data

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The current question is not "Will we have forecasting?" but, "How rapidly is it approaching?" and "How far will accountants extend their services in forecasting?"

Forecasting is one of the most controversial subjects in accounting today. A forecast may be defined as simply an "estimate" of what will take place or as a "prediction" of future results. It is not to be confused with a budget, a pro-forma statement, nor is it to be considered the company's goal. The estimate or prediction is usually expressed *quantitatively* in the form of physical units, and/or dollar values.

The purpose of this article shall be to give a brief background, to express managements' feelings, to express accountants' attitudes, to show current reporting practices in annual reports, to present the problems associated with forecasting, and to relate its current status within the profession.

History

The *Code of Professional Ethics* published by the American Institute of Certified Public Accountants *prohibits* accountants from *attesting* to forecasting with the directive: "A member shall *not* permit his [sic] name to be used in conjunction with any forecast of future transactions in a manner which may lead to the belief that the member vouches for the achievability of the forecast."[1] The interpretation of Rule 204, stated above, "does not prohibit a member from preparing, or assisting a client in the preparation of, forecasts. . . . When a member's name is associated with such forecasts, there shall be the presumption that such data may be used by parties other than the client. Therefore, full disclosure must be made of the sources of the information used and the major assumptions made in the preparation of the statements and analyses, the character of the work performed by the member, and the degree of the responsibility he [sic] is taking."[2]

In February 1973, the Securities and Exchange Commission (SEC) announced it would no longer ban forecasted information in the statements of companies issued under federal securities laws. Disclosure was optional, not mandatory, provided the forecasted data was not made available to any parties as "inside information." The SEC decided that, at this time, forecasts need not be independently audited.

The report of the AICPA's study group on "The Objectives of Financial Statements," better known as the Trueblood Report, emphasized the consumer's need to make economic decisions. This group recommended that forecasts should be provided *if useful* to the user for investment purposes and for extending credit.

So, the choice is left up to the individual companies and the debate rages: to publish forecasts or not to publish forecasts?

Management's Feelings

How does management react to this issue? The international accounting firm of Coopers and Lybrand surveyed and received a response from 1300 companies.[3] The views, of course, were both negative and positive.

The negative side was expressed:

> "The view that if management can give a forecast to an analyst, it can as easily give it to the public . . . is a little like saying that, since you can give hydrochloric acid to a chemist, you can give it to a child.
>
> "We are disturbed over the evident misunderstanding of the role and uses of forecasts . . . management develops forecasts first and primarily as a basis for . . . operating decisions essential to the running of the business. . . ."

The positive view is quoted:

> "We believe that by making public earnings forecasts, management eliminates the guessing games, reduces the possibility of one source getting privileged information and creates an atmosphere in which developments can be discussed freely . . . .
>
> "We will recognize and hope stockholders will appreciate that forecasting is difficult and imprecise and that it involves the art of judgment rather than the science of accounting technique."[4]

The survey found that more than 52 percent of corporate decision makers are *against* public disclosure of financial forecasts, and that the negative reaction gets stronger the closer the executive is to the financial function.

At ASWA Eastern Regional Conference in Memphis in May 1974, Paul Bradshaw, vice-president of finance for Wayne-Gossard Corporation, said United States corporations give out more information than any other corporations in the world, yet the cry is for more information. Speaking on behalf of management Mr. Bradshaw expressed concern with the risks of inaccuracy and legal liability and the effect this might have on the credibility of the corporation. Stating that forecasts are subject to frequent revision, he believes that for many companies they are not even reasonable estimates, but rather constitute goals. He suggested that two forecasts might be required — one for internal use and one for publication.

Accountants' Attitudes

If management, in general, opposes publishing forecasts in their annual reports to stockholders, how, indeed, does the accountant react?

An article in the Winter 1974 issue of *The Ohio CPA* reports on a survey of attitudes of certified public accountants regarding financial forecasts.[5] The wide variance of opinion within the accounting profession is further supported by testimony presented in recent SEC hearings. Joseph P. Cummings of Peat, Marwick, Mitchell & Co. argued that financial forecasts are useful and feasible, . . . that they are an extension of corporate disclosure and to have credibility will need to be independently reviewed.[6]

In opposition, Harvey Kapnick of Arthur Andersen & Co. takes a strong stand against publication of financial forecasts. He believes that sophisticated analytical methods applied by mathematicians, market analysts, economists, and others requires an expertise not possessed by most accountants. Mr. Cummings would assemble such a team of experts to deal with forecasting.

Although there is disagreement on the qualifications of the accountant for evaluating forecasts, accountants do agree that the real problem is the attestation of forecasts. Although most current discussions are concerned with forecasts included in documents filed with the SEC, there is belief that the requirement will spread to other reporting areas and on a regular basis. The large accounting firms employing a variety of specialists will be able to meet these needs; however, the smaller accounting firms may encounter great difficulties in developing the necessary technical capabilities.

Practice in the United Kingdom

Current practice in the United Kingdom is that the auditor's report "*attests* that the forecasts are based on the economic, commercial, marketing and financial assumptions made by management and that the accounting bases and calculations are correct."[7] The report includes management's assumptions, but these are not attested to by the auditor. Projections that turn out to be off by more than ten percent are investigated by a review board.

Accountants in the United Kingdom hesitated in reporting on forecasts several years ago but now feel comfortable about doing so. The United Kingdom has no class action suits, no securities acts like the U.S. 1933 and 1934 Acts, and British auditors are seldom sued.

Current Reporting in the United States

With such caution and reluctancy expressed by management and accountants, it would be expected that few, if any, U.S. corporations have published forecast information in their annual reports to stockholders.

According to *Accounting Trends and Techniques*, published by the AICPA, in 1971 four companies reported that sales or earnings would increase or decrease by a specified amount or percentage. In 1972, 22 companies included such forecasts. Of these 22, four gave more information than just commentary.

Fuqua predicted net earnings and earnings per share for 1973. Its forecast was off \$20 million on 1973 earnings, or one penny on earnings per share.

Pall Corporation's annual report included a table of actual 1972 sales, forecasted 1973 sales, and backlog orders at the beginning of 1973 by major product lines.[8]

International Minerals & Chemical Corporation provided the forecast in narrative form. It listed the expected changes in 1973 income in dollars with the reasons for such changes, e.g., price increases, interest rates, etc.[9]

The LTV Corporation's 1973 operating forecast included a definition of forecasting and the assumptions made to arrive at the amounts for 1973. The basic assumptions made included a ten percent growth rate in the gross national product, continuation of Phase III wage and price controls, increases in material costs, and no significant changes in the corporate tax structure.[10]

No statistics were available at the time of this research on 1973 annual reports. Approximately 40 1973 annual reports were selected at random and reviewed for forecasting data. Not one of these 40 contained any forecasting information.

Current Problem Areas

What are some of the problem areas facing the accountant? Some of the major ones are development of the assumptions used in making the forecast, disclosure of the assumptions made, technical problems, accuracy, auditing of forecasted information, legal liability and credibility.

Assumptions made in preparing forecasts may be many or singular. Management may decide to rely upon past experience. Combined with this may be new or changed levels of activity, revised management policies and programs, and new facilities. The forecast may be predicated upon what is *likely* to occur, what is *desired* to occur, or what *could* occur. Economic factors such as price controls, interest rates, a stable money market must also be considered.

Disclosure of the assumptions made is believed to be necessary for the forecast data to have any real meaning. These assumptions may be set forth in a separate schedule or appendix — somewhat as the notes to financial statements are presented. Unfortunately, many corporate managements believe they are revealing strategic information to their competitors in so doing.

Technical problems include frequent revisions (quarterly perhaps), the time period covered, and determination of the format to be used in presenting forecasted data — an income statement, a balance sheet, and/or earnings per share.

What degree of *accuracy* is desirable for credibility? Sales is the single most difficult item to predict. Without a fairly accurate sales prediction, net earnings cannot have any degree of reliability. An empirical study by Skousen, Sharp, and Tolman revealed that a large number of corporate financial officers were confident in the accuracy of their budgetary data. Indeed, a majority of the respondents indicated accuracy to within 10 percent.[11] Other studies conducted by Bernstein and Daily support the 10 percent range. Therefore, 10 to 15 percent of net income may be the border zone between materiality and nonmateriality. This might suggest that forecasts be given for different levels of sales revenues.

Would *auditing* forecasted data serve a useful function? The British feel the audit of forecast data provides the necessary objective viewpoint, whereas before audits of forecast data were rquired, financial forecasts contained too much of management's optimism. CPA's surveyed by Skousen, Sharp, and Tolman indicated that they believed accountants could devise auditing procedures to quantitatively attest to the validity of forecasts, but not qualitatitively — that is, the reliability of the predictions made. At this date, generally accepted forecasting principles are not available. Should they be developed in the future, the extension of the attest function to forecasts may become a normal phenomenon.

Many accountants fear that their *legal liability* will be increased if they extend their opinions to include forecasts. Under common law, a fraudulent misstatement of opinion, made intentionally or by gross negligence, could result in legal action. The landmark case in this area may be the *Monsanto Chemical* case decided in October, 1971. The decision indicated there was no liability where forecasts were prepared if they later became inaccurate because of unforeseen circumstances.

Under the securities laws, liability exists for a material misstatement or omission of *fact*. The obvious question is: are forecasts fact or opinion? The SEC has indicated that it supports the latter view and that it would seek appropriate legislation to the effect that a forecast is not to be construed as a promise. Therefore, the liability for inaccurate forecasts may not be significant, especially if the SEC drafts appropriate legislation to protect issuers.

When actual financial operating performance is significantly different from that forecasted, would users question the *credibility* of accountants' opinions, not only on forecasts, but on the financial statements as well? Unless the accountant clearly states the limits of responsibility taken, there is some danger that users of forecasts could attribute more credibility to them than is warranted.

Suggested Guidelines

The accountant who assists a client in preparing published forecasts should issue a report or letter. According to Bertrand J. Belda, the letter or report should *disclose:*

1. the purpose of the forecast,
2. the extent of the accountant's participation,
3. the sources of information used,
4. the major assumptions made,
5. the extent of responsibility taken, and
6. a disclaimer regarding the reliability of the forecasts.[12]

Current Developments

Late in the spring of 1974 the AICPA's management advisory services committee approved and exposed for comment a draft statement "Standards for Systems for the Preparation of Financial Forecasts." The draft proposes ten basic standards in developing forecasts for financial results on a recurring basis. The standards cover such areas as personal characteristics, competence, supervision, due care, and client benefit. It does not deal with reporting, disclosure, or attestation.

Another Institute group, headed by H. Barry Burris, Coopers & Lybrand, is studying the role of the CPA in reviewing and reporting on financial forecasts. This task force is expected to make recommendations to the auditing standards executive committee by the end of 1974.

The newest-formed task force on forecasting, headed by Philip Chenok of Main Lafrentz & Co. is composed of representatives from the Institute's accounting standards, auditing standards and management advisory services divisions. They expect to develop a statement on disclosures and presentation of financial forecasts.

In addition, accountants can expect a SEC statement on the filing of financial forecasts with the Commission. These releases are expected to be out in the fall.

Conclusion

The author believes that forecasting has arrived and that, no matter how much management and accountants protest and argue against forecasting, the controversy shall now settle around the issues that need to be resolved.

Footnotes

[1] *Restatement of the Code of Professional Ethics*, American Institute of Certified Public Accountants, Inc., March 1973, p. 22.

[2] *Ibid.*, p. 36.

[3] John Cunniff, "Firms Found Opposing Disclosure of Forecasts," *The Blade*, Toledo, Ohio, June 13, 1973.

[4] *Ibid.*

[5] Dale L. Kiefer and Eugene Willis, "Reporting On Financial Forecasts: A Survey of Attitudes of CPAs," *The Ohio CPA*, Winter 1974, p. 27-35.

[6] *Ibid.*, p. 27.

[7] *Ibid.*, p. 29.

[8] *Accounting Trends and Techniques 1972*, American Institute of Certified Public Accountants, Inc., 1973.

[9] International Minerals and Chemical Corporation Annual Report on the Businesses of IMC; 1972 and the Prospects Beyond, p. 7.

[10] The LTV Corporation Annual Report to Shareholders 1972, p. 6-7.

[11] K. Fred Skousen, Robert A. Sharp and Russell K. Tolman, "Corporate Disclosure of Budgetary Data," *The Journal of Accountancy*, May 1972, p. 51.

[12] Bertrand J. Belda, "Reporting on Forecasts of Future Developments," *The Journal of Accountancy*, December, 1970, p. 56.

Electronic Data Processing

Some Basic Concepts of Data Organization and Retrieval

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Machine-readable data can take many physical forms. It can appear as holes in a punched card, as magnetic spots on a strip of tape, as magnetic characters on the bottom of a check. When read into the internal storage unit for processing, it will be converted into the internal storage format of that unit. Frequently, this data will be stored and processed in the decimal numbering system, but there are increasing numbers of applications where the information is stored in the binary numbering system because of its potential for efficient machine operation. With the developments in conversion techniques (both programmed techniques provided by the vendors and hardware techniques in the newer systems), the transition between the decimal and binary numbering systems is fairly convenient and of decreasing importance when choosing a numbering system. Of much more importance than the physical arrangement of the data is the logical organization and the meaningful relationships between the various pieces of information. Basically, these logical relationships hold regardless of the physical form of storage.

Basic Units of Information

Traditionally, a basic unit of information is a data record. A data record can be considered that collection of information which records an event, transaction, or happening which is to be recognized in the information system. For example, a sale of a given item to a particular customer would be a transaction which would be recorded in a unit of information called a record. This record will have certain subparts. As an example, information to be recorded about a sales transaction would include an identification of the customer and the amount of the sale. Each of these pieces of information about that sale would be recorded in a unit of information or a subpart of that record, called a field. Figure 1 is an illustration of a record, which is recorded on a punched card with five fields of information.

Sometimes one field takes on more importance than the rest for certain operational control purposes. For example, if this particular record, which is the information about a sales transaction, is to be used to update the accounts receivable file, then the field which contains the "customer number" becomes the field by which we recognize the relationship between this record recording the sale and the record within the accounts receivable master which contains the account balance of the customer involved. When a field is used to identify relationships between records, it is called a control field.

Fields are composed of a smaller unit of information called a character. A character, which is the smallest logical unit, can be related to the physical storage media in a sense that a character usually occupies a physical recording position. The amount of space that a piece of information takes within a physical storage media is a function of the number of characters in the logical record — usually one character occupies one recording position.

A physical input or output operation will frequently cause the transfer of one data record (also referred to as a logical record) between the input-output device and internal memory. However, there are some media or forms of physical storage in which the reading or writing of a single logical record with an input or output instruction is somewhat inefficient for the hardware. When this occurs, the logical record will sometimes be grouped with a number of other logical records into a unit called a block or physical record which can be read or written with the execution of a single input or output instruction. This technique of grouping these logical records so that they can be read several at

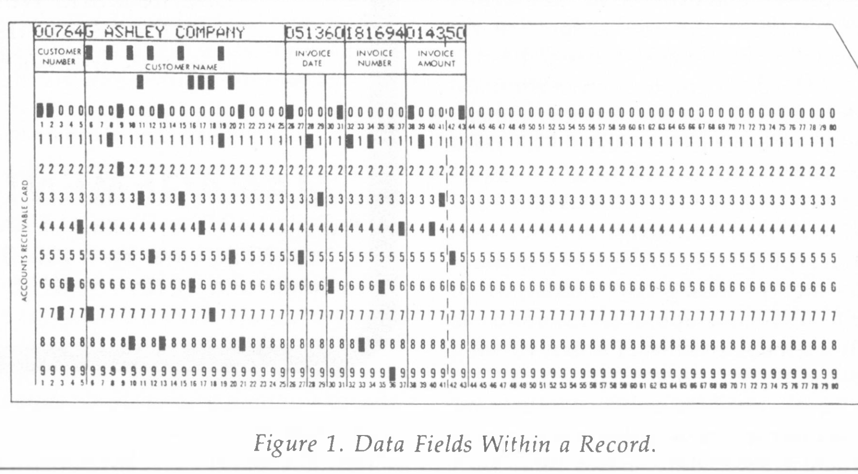

Figure 1. Data Fields Within a Record.

a time, or written several at a time, is called blocking. When this occurs, then one must distinguish between a logical data record and a physical data record. A logical data record is that group of information which records a single transaction or event. A physical record or block is that group of data characters which are read in or written out by the execution of a single input or output instruction.

A data file represents a collection of related records into a larger information unit. For example, all of the sales records for a given day (one record for each sale occurring in that day) could be collected into a file which would be the sales file for that day. Another example of a file would be the accounts receivable master file which is a collection of records showing the balance due from each customer.

Types of Data Files

Files basically are of two types. There are those files which could be designated as master files, which contain information that is usually considered permanent and which is periodically updated by transactions occurring in the normal operation of the organization. Sometimes these files are referred to as generation files. Once a file is updated, another version or another generation of that file exists. For example, the December 31 version of a master file will represent a different generation than the January 31 version which is produced by the use of January transactions to update the December 31 balances.

The frequency with which a master file is updated is dependent upon the processing cycle of the organization involved, but the principle is basically the same — master files are periodically updated; therefore, there are several generations of the same file. One of the concerns in an installation is to maintain proper identification not only of the file but also of the generations of the file.

Another type of file is that which might be characterized as a transaction file. Transaction files are not to be updated but instead contain data which will be used to update the master files. They are generally of a less permanent nature than the master files and are usually saved as long as they are needed for production of reports, or for use in an updating process, or for use in a reconstruction process.

The Trend Towards Integrated Files or Data Bases

Historically, as a given area was automated or a data processing application developed, the files were designed for that application, including the master and detail files necessary to accomplish the processing for that particular activity. As different areas were automated or separate applications developed, files for each of those applications were developed independently. As more and more of the processing activity and record-keeping activity of an organization was automated, many areas of duplication developed in the separate file systems for each application.

The duplication of data in several different sets of files represents several inefficiencies. First, it requires more storage when the same information is stored multiple times. Second, when a given transaction affects several different files which are not integrated or coordinated, it is necessary to use the transaction record in several different updating processes to update the different individual files. This can introduce inconsistencies between the similar records of separately updated files and the mere delay in execution of the multiple updating procedures can cause the information in the individual files to be at different stages of currency.

There has been a trend in the last few years to take these separate sets of files and to combine them into one integrated set of files referred to as a data base. An integrated file system provides greater processing efficiency by eliminating duplicate items currently existing in the separate sets of files. A transaction which would have affected several different sets of records in separate files through several processing runs can update the single integrated file in one processing pass.

The integrated data base, while providing greater efficiency, does, however, introduce a greater risk of damage to an organization's total information system. When each set of files is updated separately, an error in processing affects only one set of master files. The organization can continue to operate with all the rest of its data while reconstructing the particular file in error. In a single integrated file system, an error in the system can have more wide-reaching effect on the operational viability of the organization. Therefore, a great deal of effort must be expended in validating input data and additional controls procedures must be instituted to insure that valid transactions are properly processed against the correct file segments.

Data Organization and Retrieval

There are two basic approaches to data organization and retrieval — sequential and random. In a sequential file, the records are stored in some logical sequence. Usually that sequence is dictated by a field which identifies the record. This field is called the control field. For example, the records in a payroll file would be in sequence by employee number. Sequential organization has the advantage of simplicity and facilitates very efficient machine retrieval. When records are retrieved sequentially, physical movement within the input-output device is minimized. Sequential processing is characterized by passing the entire file and accessing each record in sequence. Therefore, it is most efficient in those instances where a large number of the records are active and would otherwise require access. In sequential retrieval all records in a given file are read in sequence. The efficiency of sequential retrieval is such that it is less time-consuming to access a few inactive records that would not otherwise have been read than to move the access mechanism of the input-output device in a non-sequential manner.

In those instances where many of the records in the file are relatively inactive, (that is, there are a large number of records but relatively few of them at any point need to be accessed) sequential organization and sequential retrieval loses some of its advantage. When there is a large enough percentage of inactive records in the file, the time advantage of reading the next sequential record is offset by the number of otherwise unnecessary read operations which are performed. In those circumstances a retrieval technique known as random retrieval is preferable. Random retrieval does not necessarily imply a lack of sequence in the records. Instead it refers to a particular processing technique in which only the active records are read. However, in certain processing environments, such as real-time systems, it is impossible to sequence the transactions. Under these circumstances it is necessary to use random retrieval when accessing the master file.

Random retrieval requires a hardware input-output device which is more sophisticated than that required by sequentially-organized records and which contains predetermined recording locations and an access mechanism which can be moved to those predetermined recording locations. Devices which have this ability are referred to as direct access devices (they have also been called random access devices). Direct access devices are represented in today's technology by the magnetic disk files, the drum files, and the data cells. Devices such as magnetic tape drives and the card readers are devices in which we have no predetermined recording positions other than the start of the file.

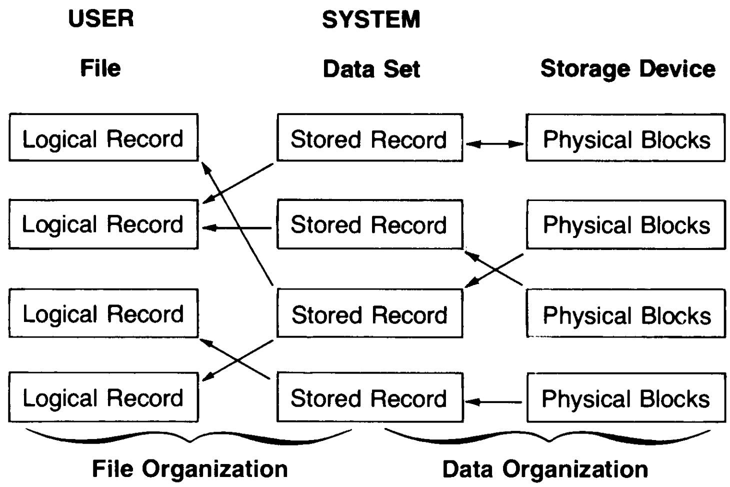

Figure 2. The Functions of Data Management

In simple unsophisticated systems there is frequently no difference between the logical organization of information as the user views it and the physical organization of the data as it is actually stored. The logical record represents that collection of information that is a meaningful unit to a processing program. Except for the concept of blocking (where several logical records may be grouped into one physical record), in most simple applications involving non-integrated files, the format of the logical record corresponds to the format of the physical record as it exists in the external storage device.

The movement toward more complex integrated collections of information that service multiple applications (a data base) has created some differences between the form of the logical record and the form of the actual physical record. The various input-output devices available with computer systems represent diverse physical characteristics just as the kinds of data and their uses vary. As information systems become more inclusive, a greater variety of processing needs are evolving at the same time that the advantages of a single integrated data base are causing a consolidation of data files.

In an integrated data base all of the individual pieces of information about a corporation's files (called segments or elements) are collected and physically stored and organized in such a way that any processing program can access any element within that data base. (This is in contrast to the approach in non-integrated files when each application sets up its own files and the file contains only records of a given type.) In the more complex environment of an integrated data base handling a variety of data and users, the need has developed for more versatile techniques for organizing and retrieving data. Frequently, the logical relationships between various data will no longer correspond directly to the physical structure of the data as stored in the external storage media.

In these integrated data systems, information storage has three basic levels of relationship: the user's concept of information involving fields, logical records and files; the system concept of data consisting of collections of stored records and files (frequently called data sets); and the device or storage concept of data consisting of physical blocks recorded on a storage media. Data management as shown in Figure 2 is the set of techniques by which the logical record of a user can be traced through the system organization to its physical storage location or by which a piece of information can be retrieved from a storage device to fulfill the need of a particular user for a given logical record of information.

File organization represents that part of data management which expresses the set of relationships between the user's definition of logically related information and the system's collection of stored records or data sets. Data organization represents that part of data management which expresses the set of relationships between the system's data sets and the physical blocks of data as they are stored in a storage medium. Generally, the functions of data management (including techniques of file organization and data organization), are provided through vendor-provided programming support. In simple systems, data management is little more than blocking and deblocking routines. In complex systems, data management represents an extensive set of programmed routines for the identification, location, and retrieval of data.

Updating Techniques and Provision for File Reconstruction

File updating occurs when information from transactions is used to change the information in a master file, thereby creating a new generation of that master file. Basically, updating can be accomplished by one of two techniques — non-destructive updating or destructive updating. In a non-destructive updating environment, the old master file is kept intact. This is done by mounting the old file on a physically separate device from that device which will do the recording of the new file. This is the technique that is employed in magnetic tape processing. It allows for the retention of several generations of a file and it does, of course, facilitate reconstruction in those instances where necessary.

When a new generation has been created through an updating procedure, it becomes the input for the next processing cycle. The old generation is retained until completion of the next processing cycle to provide "back-up" in case the current generation is damaged. After two processing cycles there will be three generations of the master file: the most recent is often referred to as the "son"; the file generation used as input to the second processing cycle (and output from the first cycle) is referred to as the "father"; and the generation used as input to the first processing cycle is referred to as the "grandfather". (See Figure 3.) Once the "son" has been successfully created, the installation no longer needs to retain the "grandfather" generation or the transactions processed against it for reconstruction purposes. Of course, any reports or other printed record of the data represented by these files will still be available.

Reconstruction in computerized activities occurs when, for one reason or another, original data in their machine-readable format are destroyed and have to be recreated. If proper thought is given to forms for saving data in their machine-readable form, this reconstruction procedure can be greatly facilitated. If, however, when machine-readable data are destroyed, the installation has to go back to original non-machine-readable forms to recollect that information, the process can be time-consuming at best.

Generally, transaction records which affect a given version of the master file are saved until such time as that master file has been used as the input to another

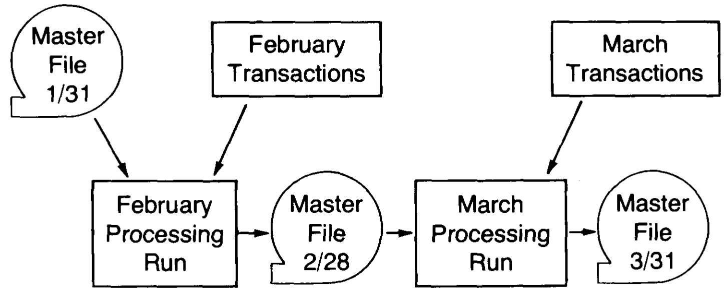

Figure 3. File Back-up with Generation Files

updating cycle in which a subsequent generation of the master file is produced. The procedure involves retention of several generations of the master file as well as all of the intervening transaction files.

Destructive updating occurs in those instances where the new version or the new generation of information is written on the same physical space as that previously occupied by the old version or old generation of the master record. This type of updating is frequently employed in direct access devices. Because the previous generation of data is destroyed in the process of updating, additional precautions must be taken in this approach to file updating. All possible checking of the transaction information should be performed before the data is used to assure its accuracy, and additional procedures should be performed during the updating procedure to insure that transactions are, in fact, being matched against the proper master transaction.

Since the "grandfather-father-son" retention technique is not viable in destructive updating as a reconstruction tool, some other procedure must be executed to accomplish this function. The usual approach is to make periodic copies of the master file, a process referred to as dumping the file. All transactions used in updating the master records since the last dump should be retained for reconstruction purposes until the next "dump" is made. Should any erroneous updating or other damage to the master file occur, it is possible to reconstruct the proper data by going back to the previous version and updating that with all intervening transactions. An alternate to periodic dumping of the entire file is the technique of logging changes to the master file as updating is being performed by writing the contents of the transaction and the master record before and after the update on a logging device (i.e., a reel of tape). Updating logs or periodic dumps can be made to another recording device similar to that containing the master file, they can be made to magnetic tape, or they can be printed out. The closer the form of the dump to that occupied by the master file, the faster the reconstruction procedure.

Summary

There is a great diversity of physical storage facilities, and file organization and retrieval techniques. Careful thought must be given to the choice of that combination of hardware and processing approach which will provide the most efficient and effective facility in relation to a given installation's circumstances. In addition to concerns for efficiency there is a continual need for adequate controls and protection of the data files and a procedure for reconstruction of those files should the need arise. This is especially true, given the trend towards centralized data bases and the frequently resulting operational dependency on the accuracy and continued availability of these information files.

Reviews

(Continued from page 22)

BEHAVIORAL ASPECTS OF ACCOUNTING, Michael Schiff and Arie Y. Lewin, editors; Prentice-Hall Inc., Englewood Cliffs, N.J., 1974; 408 pages, paperback.

Both undergraduate and graduate accounting curricula are currently including more emphasis on the behavioral sciences. A text developed for use in some newly designed courses may be of use and interest to accountants concerned with updating their skills.

The format is a series of 25 articles from economics, management science, and finance, divided into five categories: Theory of the Firm and Managerial Behavior, Budgeting and Planning, Decision Making, Control and Financial Reporting. Each section is preceded by a short introduction to the reading, including an overview of why each article was selected or what it should explain or demonstrate. A list of discussion questions follows each section. A "Selected Bibliography" of 8 pages concludes the book.

As always in a compilation of readings, some articles are very readable, others less so. Some are reprints from easily obtained journals, others would require use of a fairly well-stocked library. The convenience of the collection in one not-too-large paperback makes the volume more accessable to the accountant with minimum time.

A few of the articles contain functional symbols and equations, statistical techniques such as correlation coefficients, complex graphs, and flow charts. Others present their information totally in verbal form.

Most accountants have had some exposure to management, statistics, and economics. This paperback builds on and expands that knowledge, which perhaps has become out-of-date. The fields of management and economics have changed and expanded in recent years and have increasing implications for accounting today.

This reviewer suggests that the reader sample the book and read the introduction to each section. Benefits are not restricted to those who read the book from cover to cover.

M.E.D.

Editor's Notes

A New Editorial Policy: Non-Sexist Language

With the October 1973 issue we made two obvious changes in *The Woman CPA*: we changed the format, and we added new departments. We also made another, more subtle, change: we instituted a new editorial policy that henceforward all writing in *The Woman CPA* would be non-sexist.

By sexist language in accounting we mean the exclusive use of the male personal pronouns "he," "his," "him," etc., in references to an accountant in general, as in the sentence: "In each of his [sic] activities, the professional accountant brings to bear his [sic] unique knowledge of business." (From the AICPA's latest promotional leaflet *Accounting For The Future.*)

We object to a sexist sentence such as the one above on several grounds: it is contrary to fact since our two sponsoring organizations prove by their very existence that women, too, are accountants; it is an insult to every accountant who happens to be a woman; and it tends to perpetuate the stereotype that accountants are men.

Sexist Language and Sexual Stereotyping

We think there is a direct connection between sexist language and sexual stereotyping: male personal pronouns are used to refer to an accountant, an auditor, a manager, a supervisor, a business*man*, and so on *ad nauseum*. But female personal pronouns are used when referring to a secretary, a typist, a keypunch operator, a receptionist, and other people low on the pay scale in business.

One way of changing the sexual stereotype of any profession is to attract more people of the other sex to that profession. Our two sponsoring organizations were founded to do just that. But can we interest women in a career in accounting when all the subtle signals in the literature say: accounting is for men only? And these signals are there, in the career pamphlets, the textbooks, and the professional journals.

The latest promotional leaflet of the AICPA, *Accounting For The Future*, does not even contain the word "women" and refers to accountants only by the male personal pronoun (see the sample above). The pictures in the leaflet send the same message. Of the four pictures two contain only men: on the cover picture they are in front of an imposing office building, and in another picture they are in the field with some heavy machinery. The other two pictures contain one woman each, but the situation in which she is shown is ambiguous, to say the least. In one of them she bends over two men sitting at a table, and it is not clear whether she is their equal or a secretary receiving instructions. The other picture shows a man and a woman in front of a computer with him pointing at some figures and her looking on. Again it isn't clear from the picture whether she is working with him or for him.

If the young woman isn't turned off by this leaflet and enrolls in accounting courses, she again gets the same message. Two popular textbooks can prove that. The 5th edition of Simons' *Intermediate Accounting*, published in 1972, says in the first paragraph of the preface that "the accounting major makes important progress in his [sic] chosen field . . ." And Finney and Miller's 6th edition of their *Principles of Accounting – Advanced*, published in 1971, illustrates the point with pictures at the beginning of chapters. Only two women appear in the pictures and they look like a keypunch operator and a librarian, whereas men are shown in business situations, such as sitting around a conference table.

To pick one article out of the wealth of professional journals is manifestly unfair. But we chose this article because it conveys a specific message. The article is "The Generation Gap in Public Accounting," by Sorensen and others, published in the December 1973 issue of *The Journal of Accountancy*. The authors took a survey of students, staff accountants, and partners and refer to the respondents of their survey by using "he or she" (p. 44). But when they refer to a partner (p. 44) or a CPA (p. 46), they use only the male pronoun. The message sent by this language is clear: women may enter the profession, but they don't make it to the top.

In our struggle to change the stereotype that accountants are men we have, unfortunately, just been abandoned by a powerful ally, the Education Division of the Office for Civil Rights in the Department of Health, Education, and Welfare (HEW). Even though HEW recognizes that Title IX of the Education Amendments of 1972, which forbids sex discrimination in colleges and universities, could well apply to sexism in textbooks, it shies away from taking that stand. In the recently published proposed guidelines to Title IX HEW instead takes the position that to prohibit sexist language and sexual stereotyping in textbooks *may* violate the right of free speech under the First Amendment to the Constitution. The only way to find out whether sexist language is, indeed, Constitutional, is to test it in the courts. So if HEW could be persuaded to change its position, Male Chauvinist Persons would have to go to court to find out whether sexist language is protected by the US Constitution.

Webster Was an MCP

When we women accountants object to sexist language in accounting, such as the examples above, we are generally told that the male personal pronoun "he" refers equally to a man and a woman. That would be true if women had been the equals of men during all the centuries while the English language evolved. But we know that we were not equal, that we are not equal, and that we will not be equal until the Equal Rights Amendment is ratified. It is obvious to us that, when the Founding Fathers wrote "all men are created equal" in the Declaration of Independence, they meant just what they said: all men are created equal, but women are created as appendages to men (viz. Mrs. John Doe who lost not only her last but also her first name). So to the contention that "he" also means "she," and if you don't believe it, just look it up in your dictionary, our answer is: Webster was a Male Chauvinist Person.

Non-Sexist Language

Another answer we get when we object to sexist language is that it is awkward to always say "he or she" instead of just "he." That is true, but it is awkward only because we aren't used to it — yet. Ten years ago the word "negro" came naturally, whereas the word "black" was awkward. Today, we are used to it.

When we changed our editorial policy a year ago, we didn't tell you about it because we wanted to see whether we could eliminate sexism from our writings without sounding so awkward that you would comment on it. If your non-response is any indication, we succeeded.

There are numerous ways of eliminating sexism from the English language. Using both the male and female personal pronouns is only one way. Another, very simple, way is to put nouns into the plural and then to refer to accountants as "they." Very often the personal pronoun can be taken out of a sentence without altering the meaning. For example, the word "his" is not really necessary in the phrase: "in relations with his clients the accountant must . . ." It is also possible to repeat the noun without violating all the canons of good English, especially if the sentence is fairly long. Or another noun with a similar meaning can be substituted for the male personal pronoun so that the accountant becomes the practitioner and the taxpayer becomes the client later in a sentence or in the next sentence. And when all else fails, the whole sentence or a series of sentences can be re-written to make the language non-sexist.

Until this issue we have only changed our own language to avoid all sexism, but we have left the sexism in direct quotations undisturbed. Since a direct quotation has to reproduce the original words in every letter, we can't substitute "he or she" for "he." So we had to find another way to disassociate ourselves from such language. Fortunately there is a simple way of doing just that. Whenever a statement contains an error in spelling or in fact, the person quoting such a statement directly will indicate that he or she is aware of this error by inserting the word "sic" in brackets right after the incorrect spelling or fact. So from now on we will show our awareness of the incorrect use of male pronouns and male nouns by this device, as we did in the quotation from the AICPA leaflet at the beginning of this Editorial.

EVENTS OF INTEREST TO BUSINESS WOMEN

In recent months eleven women made headlines when they were ordained as priests contrary to the canons of their church. Other women have engaged in equally startling activities without getting the same headlines. So we decided to do our part to publicize their activities.

On the East Coast women are getting together to form new banks. A group of women in Connecticut is in the process of starting the First Women's Bank and Trust Company in Greenwich. And in New York City Madeline H. McWhinney, formerly an Assistant Vice President of the Federal Reserve Bank of New York, has assembled a group of women and men to form The First Women's Bank with an initial capitalization of 200,000 shares of $10 par value stock. Unfortunately the present tight money markets with the resultant high interest rates are delaying the opening of The First Women's Bank.

Of special interest to our two organizations is the proposed Board of Directors' intention to retain Touche Ross & Co. as auditors for The First Women's Bank. We think the fact that Touche has several women partners — one of whom, Mary Jo McCann, served as Editor of *The Woman CPA* — played a major role in the selection of the auditing firm.

Another development in New York City may be of more immediate interest to our readers. There two women, Anne P. Hyde and Janet E. Jones, have formed Management Woman, Inc. for the purpose of placing qualified women and minorities in executive positions in business with salaries ranging from $20,000 to $60,000. Already a substantial proportion of AWSCPA members are in that salary range (see Table 5 in "The Woman CPA: A Professional Profile," by Dr. Elise G. Jancura, CPA, in our July 1974 issue, p. 3), but more money never hurt anybody in times of double-digit inflation.

And in Cambridge, Massachusetts, something is being done to help us and other women in male-dominated professions attract more young women to our fields. There ABT Associates Inc. has received a Federal contract for the development of a self-administered learning kit for career counselors in high schools. The purpose of the kit is to teach high school counselors to eliminate sex-role stereotyping from their counseling activities. Part of the kit will be a Resource Guide containing information about women in the labor force, sex-role stereotyping, and career guidance as well as a list of available materials, such as books, articles, newsletters, journals, and films. Our two organizations will be represented by our film "Why Not Accounting?" and by *The Woman CPA*.

IN MEMORIAM

During this past summer our two sponsoring organizations lost two valued members both of whom served on the editorial staff of The Woman CPA:

Doris L. Bosworth, CPA, served as Tax Editor for 25 issues from December 1965 to January 1970. She worked for many years in the tax department of Peat, Marwick, Mitchell & Company in New York City and served as president of the New York Chapter of ASWA during the administrative year 1966-67. Ms. Bosworth's Tax Forum was always informative, interesting, and understandable to anybody in accounting, no matter what their area of special interest was.

Julia J. Kaufman was first appointed to the Editorial Board on October 1, 1969, and reappointed to another 3-year term on October 1, 1972. She owned her own accounting practice in Cleveland, Ohio, and served as National President of ASWA during the 1967-68 administrative year. Ms. Kaufman's sensible, down-to-earth suggestions and gentle criticisms made her a valuable member of the Editorial Board, not only to successive editors and associate editors but also to the authors of accepted and rejected manuscripts.